Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill

Bill Number 65-1

Regulatory Impact Assessments and Statements

Prepared by Policy and Regulatory Stewardship, Inland Revenue

September 2021

Impact Summary: Domestic transport services supplied as part of the international transport of goods

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be made by Cabinet.

Key Limitations or Constraints on Analysis
Number of affected parties and potential future fiscal risks are unknown The potential fiscal risks that affected GST-registered taxpayers are choosing not to follow the existing rules is unknown. While officials have undertaken public consultation on this issue and members of the tax community have indicated that there is limited voluntary compliance, affected taxpayers have not indicated the level of voluntary compliance. Therefore, it is not possible to accurately estimate the level of non-compliance and the level of fiscal risk. The options considered in this Impact Summary are limited to those which would be suitable for inclusion in the next omnibus tax bill. Accordingly, the analysis is limited to options which have already been identified and discussed during consultation with stakeholders.
Responsible Manager (signature and date):
Graeme Morrison Policy Lead Policy & Regulatory Stewardship Inland Revenue 31 May 2021

Quality Assurance Reviewing Agency:
Inland Revenue

Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Domestic transport services supplied as part of the international transport of goods* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.
Reviewer Comments and Recommendations:
The reviewer’s comments on earlier versions of this regulatory impact assessment have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

The GST Act allows for GST to be charged at 0% (known as zero-rated) for services provided to transport goods to and from New Zealand (NZ) and, in certain circumstances, the transport of goods within NZ (the domestic leg) as part of the international transport of goods may also be zero-rated. This is because exported goods are zero-rated, and the value of transport services is already included in the cost of imported goods which are subject to 15% GST.

For the domestic leg of transport services to be zero-rated, the primary transport supplier must also supply the domestic portion of the international transport of goods. This means that if an NZ based courier is subcontracted by the international transporter to provide the domestic transport services as part of the international transport of goods, the NZ-based courier should charge GST on the supply. This applies even if they are associated with or owned by the international supplier.

The problem is that under current practice, most international transporters do not undertake the domestic leg of the transportation, and instead subcontract to an NZ-based courier. The current rules have led to a lot of non-compliance in the industry, as many goods transporters within NZ are incorrectly zero-rating their domestic services. A lot of this is due to lack of understanding of the requirement that for the domestic leg to be zero-rated it must be supplied by the same supplier as the international transportation. There is also commercial pressure for suppliers of domestic transport services to zero-rate, especially when the recipient of the supply of the domestic transport (being an international supplier) is not registered for NZ GST.

2.2 Who is affected and how?

Final consumer: The current rules may create tax cascades[1] whereby a business that is not registered for GST (off-shore supplier) is charged GST by a domestic courier undertaking the domestic leg of transportation. The GST charged to a non-registered business by the supplier cannot be refunded by Inland Revenue (if you are not registered for GST you cannot claim any inputs) thereby leading to the GST being embedded in the price charged for the international transportation, and thus passed on to the final consumer.[2]

Domestic couriers: The current rules create a bias towards the international transport supplier of the international transport services also supplying the domestic transport services (as it would be zero-rated). This theoretically lowers demand for the domestic couriers service. Secondly, in the event the domestic courier is chosen, there is a lot of pressure on them to incorrectly zero-rate the domestic leg services (anecdotally this is what officials understand happens in practice but could potentially open the domestic leg supplier up to liability).

International couriers: Creates inefficiencies as international transporters are required to either register for NZ GST (to claim inputs on the GST cost charged by domestic

[1] Whereby a business absorbs the GST cost that is otherwise irrecoverable and passes this additional cost on to its customers as part of the sales price.

[2] This tax cascade could be avoided if the non-resident business chose to register for NZ GST (either under section 51 of the GST Act if they have a taxable activity in NZ or under section 54B if they do not make taxable supplies in NZ but do incur GST). However, this solution is not always pragmatic.

couriers for the domestic leg) or carry out the domestic leg of transportation themselves, despite it not necessarily making best business sense to do so. As the current rules incentivise international couriers to undertake the transportation themselves, this also affects competition. There is also an incentive for the transporters to deliver goods through the postal service, as the full value of international postal services is always zero-rated (whereas for courier services the domestic leg is currently subject to GST).

2.3 What are the objectives sought in relation to the identified problem?

- That the tax settings do not bias business decisions by favouring the use of certain courier companies over others.
- To avoid tax cascades and other additional costs being passed on to the final consumer (it is appropriate for the final consumer to bear the GST cost).
- To ensure ease of compliance: to ensure that the rules in this area are clear and easy for transporters to follow and apply.

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options:

- Certainty: It should be clear how the tax rules operate so that affected parties can plan their affairs accordingly.
- Fairness: It is appropriate under fundamental GST principles that the final consumer bears the GST cost. However, we want to avoid tax cascades that occur when, by virtue of not being registered for GST, a taxpayer is unable to claim input tax deductions for goods/services that are used in their taxable activity. This results in additional GST costs, which would otherwise be recoverable by the GST registered party, being imbedded in the final price paid by the consumer.
- Tax considerations should not bias business decisions: The GST treatment of transport services should not bias investment decisions.
- Consistency with other jurisdictions: It is important for these rules to be consistent with other jurisdictions, so NZ will remain a competitive market for the buying and selling of goods which are required to be transported overseas (for example Australia have provisions that allow for zero-rating of the domestic leg).

Option one: Status Quo

Under the status quo the domestic leg of the international transportation of goods can only be zero-rated where the domestic leg of the transportation is supplied by the same supplier as the international leg of the transportation, excluding subcontract arrangements widely used in New Zealand.

Option two: Zero-rating domestic transport services if the primary transport supplier contracted to transport goods to or from NZ is non-resident

Under this option, domestic transport services supplied to the primary transport supplier contracted to transport goods to or from NZ will be zero-rated if the primary transport supplier is a non-resident. For the sake of clarity, this policy setting would apply where an international transport supplier is contracted to deliver goods from point A outside NZ to point B inside NZ, and, point B *inside* NZ to point A *outside* NZ.

Pros:

- Provides certainty and reduces compliance costs by aligning with existing business practices of zero-rating all transport on international courier items (to the extent the primary transport supplier is non-resident).
- Removes the tax incentive for the primary transporter to also undertake the domestic leg.
- By reducing the compliance costs associated with sub-contracting, the proposal may improve competition and increase efficiency.
- This approach is similar to Australia and Singapore. Alignment with other countries may make compliance easier for international transporters if they are already familiar with the rules in those countries.
- Domestic providers will be able to provide more competitive pricing without having to account for the GST component of the transaction.

- Solves tax cascades and commercial pressure put on domestic transporters: The rationale for allowing zero-rating of domestic transport services only if the primary transport supplier is non-resident is because non-residents are much less likely to be registered for NZ GST. The issues of tax cascades and commercial pressure to zero-rate only arise when the recipients of the transport services are not registered for GST. In cases where the transporter for the international leg of transportation is NZ resident (and thus highly likely to be registered for GST), this transporter can claim an input tax credit and there is no GST cost of transportation being absorbed in the cost borne by the end consumer.

Cons:

- Some GST revenue is foregone by virtue of the wider scope for zero-rating (up to $200k pa fiscal cost, but slightly less than option three).
- There still may be some lack of certainty as it may be difficult for the domestic leg transporter to always determine whether the primary transporter is non-resident.
- There may be theoretical gaps in cases where a NZ-resident international transporter is not GST registered (highly unlikely). In these cases GST would be charged and there would be no ability to claim inputs (tax cascade issue therefore remains).

Option three: Zero-rating all domestic transport services supplied to a primary transport supplier contracted to transport goods to and from NZ, regardless of the residency of that primary transport supplier

Under this option, all domestic transport services supplied to the primary transport supplier contracted to transport goods to or from New Zealand will be zero-rated.

Pros:

- Lower compliance costs on domestic transporter: The domestic transporter would only be required to determine whether the goods delivery service they are undertaking relates to an international transport service. They would not be required to verify the residency of the primary transport supplier (which is an additional compliance step required under option two).
- Also has the following pros similar to option two:
  - removes tax incentive for the primary transporter to also undertake the domestic leg
  - solves the problem of tax cascades
  - reduces compliance costs of sub-contracting which improves competition and efficiency
  -similar to law in Australia/Singapore
  - allows the domestic leg transporter to offer more competitive pricing
- This option accords with current commercial practice of simply zero-rating the domestic leg of transportation (although this commercial practice is currently non-compliant, it does not require the domestic leg transporter to consider whether international transporter is non-resident).

Cons:

- As with option two, some GST revenue will be foregone ($200k pa)[3] on the domestic leg of transportation due to zero-rating (or in the case of NZ registered transporters, the GST impost would be removed by claiming an input tax deduction).

Option four: Encourage non-resident businesses to register for NZ GST

Under this option, non-resident businesses will be encouraged to register for New Zealand GST so they can claim their GST input deductions, removing the possibility of the GST becoming irrecoverable and embedded in the price of the service.

Pros:

- If non-resident businesses were GST registered then they would be able to claim their GST inputs, and thus the issue of tax cascades would not apply.
- Does not require legislative amendment, only guidance.
- No fiscal cost (although being GST registered means the transporters could claim inputs they would also pay output tax as well as GST would still be charged on the domestic leg).

Cons:

- Any success of this proposal is contingent on non-resident businesses registering for NZ GST. This is considered unlikely.
- Increases compliance costs as transporters would have to enquire as to the GST registration status of the primary transporter (therefore also a lack of certainty).
- Does not increase competition – non-resident business is disincentivised from choosing another transport supplier, even if it makes good commercial sense to do so, due to tax considerations.

3.2 Which of these options is the proposed approach?

Option three is the preferred option – to zero-rate all domestic transport services supplied to a primary transport supplier contracted to transport goods to and from NZ, regardless of the residency of the primary transport supplier.

This option is preferrable because it results in lower compliance costs on transporters, as they will not suffer the compliance costs of trying to determine whether the primary transport supplier is non-resident (as they would under option 1). It also increases efficiency as tax considerations would no longer drive business decisions (i.e. this option completely removes the tax incentive for the primary transporter to also undertake the domestic leg).

It is noted that option three would also not have any measurable increase in fiscal costs when compared to option two. Our understanding of current business practices is that in nearly all cases, the primary transport supplier is registered for GST and/or the subcontracted courier treats their domestic leg services as zero-rated. In either of these cases, the proposed change will not change the total amount of GST collected, but will reduce compliance costs.

[3] This is slightly higher than option 2 due to its broader scope but differences should be nominal.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties (transporters of goods)	No cost.	None
Regulators (Inland Revenue)	Zero-rating domestic transport services will result in a lower tax take for the Government. It is noted that this fiscal cost would be nominal as in nearly all cases the primary transported is either registered for GST and/or the subcontracted courier treats their domestic leg services as zero-rated. In terms of non-monetised costs, these changes will bring a very small administrative cost to Inland Revenue in terms of providing guidance to transporters on what the new rules are in order to aid taxpayer understanding and promote compliance.	$200k pa approx. GST foregone
Wider government	No expected costs	None
Other parties	Not applicable.	Not applicable
Total Monetised Cost		$200k pa
Non-monetised costs		Low

Expected benefits of proposed approach, compared to taking no action		
Regulated parties (transporters of goods)	Transporters undertaking the domestic leg of transportation may see an uplift in their business. This is because the proposals remove the tax incentive for international transporters to also undertake the domestic leg of transportation. This will reduce compliance costs associated with sub-contracting which may improve competition and increase efficiency. There would also be no commercial pressure placed on domestic transporters to incorrectly zero-rate (as zero-rating would be permissible under the law).	Low

Regulators	Creates certainty in the law (as current law is misunderstood).	Low
Wider government	Not applicable.	Not applicable.
Other parties (end consumer)	The end consumer should pay a lower overall cost for goods. This is because the proposed policy solution will reduce the compliance costs associated with sub-contracting. This will lead to improved competition, increased efficiency and potentially lower prices. In circumstances where GST was previously charged, the proposals will eliminate tax cascades (GST charged on the domestic leg will not be imbedded in the final cost of the goods).	Low
Total Monetised Benefit	None.	Not applicable.
Non-monetised benefits	As above, the proposals would remove the tax incentive for the international transporter to also undertake the domestic leg. This could result in an uplift in business for domestic carriers.	*Medium*

4.2 What other impacts is this approach likely to have?

There are unlikely to be any further material impacts of this approach.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Who has been consulted?

This issue was consulted on as part of the release of the *GST policy issues – an officials' issues paper*. Inland Revenue received 9 submissions on the domestic leg of the international transport of goods proposals.

What was the nature of their interest?

Submissions were generally positive of the proposed changes, with several submitters noting that it needs to be a clear and easily understood definition of what constitutes the international transport of goods, to ensure the new rules do not inadvertently add another layer of complexity.

Several submitters noted their preference for the zero rating treatment to be on all domestic transport services where they relate to an international transport service, instead of relying on the tax residency of the primary transport supplier. This approach would remove complexity in determining the correct GST treatment of the transport service.

Do they agree with your analysis of the problem and its causes?

Yes. The submissions received on this issue in the GST issues paper outlined similar concerns to what has been discussed in this RIA (see above and in the pros and cons section of the discussion options).

Do they agree with your proposed approach?

Submitters preferred a broad zero-rating rule and this is the approach we are implementing (see option 3).

Has your proposed approach been modified as a result of stakeholder feedback?

Yes. When officials initially consulted on this in the issues paper we proposed allowing domestic transport services to be zero-rated only if supplied to a non-resident. The issues paper posed a question to submitters as to whether this rule should be extended more broadly to all domestic transport services supplied as part of the international transport of goods, regardless of the residency of the primary transport supplier.
Submitters supported the broader approach. Having considered this issue in greater detail officials have now opted to recommend the broader solution.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
An amendment will be required to the Goods and Services Tax Act 1985 to give effect to this proposal. This could be included in the next available omnibus tax bill (expected to be introduced in August 2021). Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with Select Committee and after the bill is enacted (by way of inclusion in a Tax Information Bulletin). The proposals have been subject to consultation via a GST issues paper and would be subject to the standard legislative process. It therefore follows that there will be sufficient time for people to react to and understand the changes (which it is noted are simple in nature). As these changes generally align with existing taxpayer practices there are unlikely to be any significant implementation risks.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
We will continue to engage with submitters and other stakeholders to ensure the rules are operating correctly and to determine whether any remedials or further changes are required. As the proposal is taxpayer friendly, compliance will be voluntary and enforcement/extensive monitoring is not necessary.

7.2 When and how will the new arrangements be reviewed?
There are no plans to review these changes. This is because the changes are taxpayer friendly and therefore compliance will be voluntary. That said, we will continue to engage with submitters to ensure the proposals deliver the desired outcome in terms of improved efficiency and a reduction in compliance costs. As officials have developed relationships with stakeholders throughout consultation on the issues paper, this engagement channel is open to stakeholders should they wish to provide feedback on the legislation.

Impact Summary: GST apportionment

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be made by Cabinet.

Key Limitations or Constraints on Analysis
The options considered in this Impact Summary are limited to those which would be suitable for inclusion in the next omnibus tax bill. Accordingly, the analysis is limited to options which have already been identified and discussed during consultation with stakeholders, would represent minor improvements to the existing rules, and would not require substantial changes to current taxpayer practices. A further round of consultation will be used to develop some major reform options to replace the current apportionment rules with much simpler rules. As this consultation is being used to develop the problem definition and identify major reform options, we are not seeking Cabinet decisions on these options currently, and a subsequent RIA will be prepared to analyse the major reform options at a later date.
Responsible Manager (signature and date):
Graeme Morrison Policy Lead Policy & Regulatory Stewardship Inland Revenue 31 May 2021

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *GST apportionment* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of this Regulatory Impact Assessment have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Background

The GST Act includes a set of apportionment and adjustment rules for determining GST input tax deductions when an asset such as a vehicle, farmhouse or home office is used partly to conduct a GST registered business and partly for a private or exempt use.

Officials do not hold data on how many of GST registered persons would be required to apply the GST apportionment rules, although it would be a small percentage of all registered persons (as most assets are solely used for business purposes).

In 2020, there were 660,000 GST registered persons (mostly businesses). Most GST registered persons are small businesses - 70% have less than $250,000 of annual sales.

Current law

The current GST apportionment rules are complex and prescriptive. This can impose two types of problems on the affected GST registered suppliers, high compliance costs and unfair outcomes for some taxpayers.

Anecdotal information from tax advisors suggests that understanding of the GST apportionment rules, and therefore compliance with these rules, is very low among smaller businesses and the self-employed.

Inland Revenue consulted on some discrete, technical issues with the GST current apportionment rules in 2020. These issues were:

The GST apportionment rules overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices. For example, if a GST registered person purchased a house, used 20% of the property to run their consulting business and some years later sold the house at a higher price, they would be required to pay GST output tax based on the full gain in value of the house, rather than just 20% of the gain which relates to the 20% of the property used in their business.

The current rules are prescriptive and complex to apply. They do not generally accommodate reasonable calculation methods which may have lower compliance costs. However, large GST registered suppliers with more than $24m of annual turnover (about 3,700 businesses or 0.56% of all registered persons) can apply to Inland Revenue to approve an alternative apportionment method (this is currently used by large financial institutions and retirement villages). The rationale for this limitation is that larger suppliers generally have more complex arrangements so were more likely to face high compliance costs under the ordinary rules. Consequently, smaller suppliers do not have an opportunity to reduce their compliance costs by applying to use a method which would have lower compliance costs than applying the main rules.

Officials recommend addressing these discrete issues as part of a first phase of a wider apportionment project.

However, the submissions and subsequent discussions with tax advisors have raised more fundamental concerns with the complexity of the current apportionment rules and the fact that understanding of the GST apportionment rules, and therefore compliance with these rules, is very low among smaller businesses and the self-employed – particularly in relation to houses which are partly used to conduct a registered person's business activity.

To address these concerns, a further round of consultation will be used to develop some major reform options to replace the current apportionment rules with much simpler rules. As this consultation is being used to develop the problem definition and identify major reform options, we are not seeking Cabinet decisions on these options currently, and a subsequent Regulatory Impact Statement will be prepared at a later date on the major reform options which will be progressed as a second phase of reforms.

2.2 Who is affected and how?

The apportionment and adjustment rules apply to GST registered persons who use an input (usually a capital asset) for a business purpose and also for a non-taxable (such as private use or a residential rental) purpose.

The issue of appreciating assets being overtaxed mainly affects residential or rural land and houses that are partly used for a business use. It generally affects GST-registered sole traders who use part of their own house to conduct their business, or who intend to use part of their own house to conduct their business. It is less likely to affect other taxpayers, because under other common ownership structures such as where the business is a company or partnership, or the house is owned by a company or trust, the house is not owned by the GST registered person, and the sale of the house is not subject to GST.

The ability to apply to Inland Revenue to approve an apportionment method is currently limited to GST registered persons who have more than $24m of annual turnover. The proposal would benefit GST registered persons who have less than $24m of annual turnover as it would allow them to apply to use a calculation method which has lower compliance costs than the default rules. We do not know how many smaller suppliers would apply to use an alternative calculation method but we expect the overall uptake will be low, as most suppliers do not need to apportion their inputs and there has been low uptake for alternative methods by larger suppliers.

2.3 What are the objectives sought in relation to the identified problem?

The objective is to improve the fairness of GST outcomes and reduce the compliance costs imposed under GST apportionment and adjustment rules.

Section 3: Options identification

3.1 What options have been considered?

The following criteria was used to assess the options:

- Fairness. The option does not over tax or under tax the non-business use of the relevant asset. It also provides reasonable GST outcomes for the affected taxpayers compared to other taxpayers who have similar circumstances.
- Compliance costs. Compliance costs should be minimised as much as possible.
- Ease of implementation. The option is discrete, simple and can be implemented quickly through the next available tax bill or a non-regulatory mechanism.
- Sustainability. The option is less likely to need to be amended or replaced in response to developments over time, particularly in relation to second phase which will consider major reforms to simplify the apportionment rules.

Overtaxing the sale of appreciating assets

Option 1: Status quo

Pros:

Not rushing to solve this issue would allow a fuller range of options to be considered as part of the consultation process to develop major reforms to the apportionment rules. Some of these major reform options could be more effective.

Cons:

Affected taxpayers who comply with the GST rules are overtaxed relative to taxpayers who own their assets though an entity. This is unfair and could discourage compliance with GST and their other tax obligations.

Unlikely to be sustainable as some tax advisors are raising concerns about the unfair outcomes that can arise under the current rules and how they conflict with current practices.

Option 2: Allow a deduction which correctly reflects the non-taxable use of the asset

Pros:

Improves fairness by ensuring the GST rules do not overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices, by allowing a deduction which correctly reflects the non-taxable use.

Option 2 involves a simple amendment which can easily be implemented in the next taxation bill. The proposal has been consulted on and was supported by tax advisors which submitted on the GST policy issues paper.

Option 2 ensures that compliant taxpayers would not be overtaxed in respect of their non-taxable use of the asset which may encourage better compliance. We have assumed that any of the affected taxpayers that do return GST on the sale of their house are only returning GST in respect of the percentage of the house used for business use. This assumption is supported by the fact that some tax advisors have told us they consider another existing rule in the GST Act may apply which provides for the same outcome as option 2, although the application of this rule is uncertain so a regulatory solution is preferred to provide certainty that a deduction can be taken to correctly reflect the non-taxable use.

Cons:

This option does not align with current behaviour of the affected taxpayers, which is not to account for GST on their own home, even if it is used partly for business. Based on discussions with tax advisors, officials understand that very few of the affected taxpayers are currently returning GST on the disposal of their homes.

The affected sole traders are likely to consider that the GST outcomes under this option are still unfair as they would face GST liabilities on their homes which would not arise for similar taxpayers which use other common ownership structures. For this reason, option 2 is unlikely to sufficiently address stakeholder's concerns and a second phase of consultation on wider reform options will be developed and consulted on.

<u>Option 3: Treat houses (and potentially other assets) which have a small amount of taxable use as being fully non-taxable.</u>

Pros:

This option would be consistent with the behaviour of the affected taxpayers, which is not to account for GST on their own home, even if it is used partly for business. This reduces compliance costs as the GST rules would align with current practices.

Could improve fairness by ensuring sole traders do not pay more GST than other common ownership structures such as where the business is a company or partnership, or the house is owned by or a company or trust.

Cons:

Difficult to implement quickly as this option has not been designed yet or developed through consultation, which increases the risk the option is ineffective (e.g. if it is too difficult to use) or creates other unintended consequences (such as under taxing private consumption). Furthermore, the planned consultation process is necessary as there is a range of ways to design this option – for example Australia's GST rules exempt all sales of existing residential properties and zero-rate all farm sales (including the farmhouse), whereas the UK and Singapore allow GST registered suppliers to elect to not claim input tax deductions on purchasing assets in which case the sale of that asset is non-taxable. Until consultation occurs, it is not obvious which option, or combination of options would best achieve the policy goals. Consultation is also needed to develop appropriate transitional rules for registered suppliers and assets which are applying the current apportionment rules to retrospectively apply or transition to the new rules.

Prescriptive rules do not accommodate simpler methods

<u>Option 4: Status quo</u>

Pros:

Not rushing to solve this issue would allow a fuller range of options to be considered as part of the consultation process to develop major reforms to the apportionment rules. Some of these major reform options could be more effective

Cons:

High compliance costs would persist until the major reforms are developed and implemented.

<u>Option 5: Allow smaller GST registered suppliers to apply to Inland Revenue to approve a different apportionment method.</u>

Pros:

Improves fairness as all suppliers would have an opportunity to reduce their compliance costs by applying to use a method which would have lower compliance costs than applying the main rules.

Quick and simple to implement as involves removing a turnover threshold and the increased demand on Inland Revenue resources is not expected to be too high.

Cons:

Would only be effective at reducing compliance costs to the extent that suppliers apply to use a different method. We do not know how many smaller suppliers would apply to use an alternative calculation method but we expect the overall uptake will be low, as most suppliers do not need to apportion their inputs and there has been low uptake for alternative methods by larger suppliers. If uptake is a lot higher than expected there is a risk that Inland Revenue may need to allocate additional resources to processing applications..

<u>Option 6: Replace the current prescriptive apportionment rules with a self-assessed rule that allows any fair and reasonable apportionment approach to be used.</u>

Pros:

Because the apportionment method is not prescribed in legislation, this option provides the most flexibility for methods with lower compliance costs to be developed over time and tailored to the specific circumstances and commercial information held by the supplier.

Cons:

Creates uncertainty and inconsistent practices as there is no main rule as a guide for what GST outcomes the method should be aiming to achieve. Inconsistency will lead to unfairness such as one supplier using a much more generous method than comparable suppliers (who may be their competitors). It could also increase disputes with Inland Revenue. There would be pressure for Inland Revenue to produce guidance on what methods are acceptable to use, which may mean a prescriptive approach eventually returns in the guidance. For these reasons this option is not considered sustainable.

3.2 Which of these options is the proposed approach?

Options 2 and 5 are the preferred options as they can easily be implemented in the next taxation bill and have been consulted on and supported by stakeholders / submitters.

Option 2 would improve fairness by ensuring the GST rules do not overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices, by allowing a deduction which correctly reflects the non-taxable use.

Option 5 option would allow smaller GST registered suppliers to apply to Inland Revenue to approve a different apportionment method which has lower compliance costs than the main rules.

While the proposed options are a clear improvement from the status quo, they are unlikely to be considered by the affected parties as a complete solution to their concerns with the current apportionment rules. To address this, officials will further develop and consult on option 3 along with a range of other major reform options as part of a second phase of reforms aimed at simplifying the GST apportionment rules.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties *(GST registered persons with business and non-taxable use of an asset)*	Unlikely to change the current practices for the vast majority of affected parties. A few regulated parties may face higher costs from seeking tax advice or assistance in respect of the proposals.	Low
Regulators *(Inland Revenue)*	More contacts with regulated parties seeking an alternative apportionment method, but demand for this process is expected to be low so can be met with existing resources.	Low
Wider government	No expected costs as the proposed approach is unlikely to change current practices and therefore the GST positions taken by the affected parties.	Unable to estimate
Other parties	No expected costs	N/A
Total Monetised Cost		Unable to estimate
Non-monetised costs		Low

Expected benefits of proposed approach, compared to taking no action		
Regulated parties *(GST registered persons with business and non-taxable use of an asset)*	Reduced compliance costs for smaller businesses which choose to use a simplified apportionment method.	Low
Regulators *(Inland Revenue)*	Because compliant taxpayers will no longer be overtaxed in respect of their non-taxable use of the asset this may encourage a small increase in compliance.	Low
Wider government	No expected benefits	N/A
Other parties	No expected benefits	N/A
Total Monetised Benefit		Unable to estimate
Non-monetised benefits	Benefits depend on the uptake / compliance with the proposals which is expected to be low based on the current practices of the affected parties.	Low

4.2 What other impacts is this approach likely to have?
No other impacts are identified.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

This issue was consulted on in 2020 as part of *GST policy issues – an officials' issues paper*. Inland Revenue received 12 submissions from GST advisors and accountancy firms on the GST apportionment issues.

The apportionment and adjustment chapter of the issues paper proposed a number of specific changes to the apportionment and adjustment rules. These changes were primarily aimed at addressing instances of the apportionment rules causing over and under taxation. The chapter also acknowledged the complexity of the rules and sought feedback on the ways in which the apportionment rules could be simplified and improved

Submissions mainly focussed on the complexity of the apportionment rules, with a number of submitters recommending a comprehensive review of the rules with a view to reducing complexity. Officials intend to further consult submitters and other interested parties on major reforms to simplify the apportionment rules as part of a second phase of changes.

Submissions supported the proposal to <u>allow a deduction which correctly reflects the non-taxable use of the asset (option 2 above).</u>

They suggested that it should not be limited to land and the proposal has been modified accordingly.

The option of allowing all taxpayers (not just those with more than $24m of annual turnover) to apply to Inland Revenue to agree a different apportionment was proposed by one submitter, and supported by all five of the other submitters that officials discussed this proposal with.

While the proposed options are clear improvement from the status quo, they unlikely to be considered by the affected parties as a complete solution to their concerns with the current apportionment rules. To address this, officials will develop and consult on a range of major reform options as part of a second phase of reforms.

In terms of additional context, a regulatory stewardship review of GST raised the GST apportionment rules as a key issue for consideration.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposals will require amendments to the Goods and Services Tax Act 1985 and could be included in the next available omnibus tax bill expected to be introduced in August 2021 and enacted during March 2022. Option 2 prevents over-taxation of appreciating assets which are partly used for a business and a private or exempt use, will apply from 24 February 2020, which is the date the issue and the proposed amendment was consulted on in the GST policy issues paper. This will ensure compliant taxpayers are not disadvantaged if they sell an affected property before the proposed amendment is enacted. Option 5 would apply from the date of enactment in March 2022. Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with Select Committee and after the bill is enacted by way of Tax Information Bulletin. The proposals have been subject to consultation via a GST issues paper and would later be subject to the standard legislative process including submissions to a select committee. This means there will be sufficient time for the affected suppliers to react to and understand the changes. In respect of option 5, Inland Revenue may experience more contacts from regulated parties seeking an alternative apportionment method. However, based on the existing experience of this process for large suppliers, demand for this process is expected to be low so can be met with existing resources. The monitoring processes discussed on section 7.1 will be used to identify and mitigate any other implementation risks.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
The impact of the proposed options will be monitored by meeting with the Inland Revenue staff who deal with customer issues and enquiries on the GST rules and by meeting with tax advisors and industry groups who represent the affected parties to ask them about their experiences with the rules. Any issues could be addressed through remedial amendments, improved guidance or future reform options.

7.2 When and how will the new arrangements be reviewed?
As the proposed options are minor technical improvements, no formal review is planned. Instead, the options would be reviewed using the monitoring processes mentioned in 7.1 above. Public consultation is planned on a package of major reform options for simplifying the apportionment rules as part of a second phase of reforms. This will allow stakeholders to raise additional issues and policy options.

Regulatory Impact Statement: Local authority taxation – dividends and deductions

Coversheet

Purpose of Document	
Decision sought:	Legislative changes to improve the integrity of local authority taxation.
Advising agencies:	Inland Revenue
Proposing Ministers:	Minister of Revenue
Date finalised:	17 June 2021

Problem Definition

Council-controlled organisations (CCOs) are treated as ordinary companies and are taxed to ensure competitive neutrality with the private sector. However, current tax law allows local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs. That is, local authorities are able to shelter their CCOs from tax.

This undermines the integrity of the tax system by allowing local authorities to effectively extract profits from their CCOs tax-free. This reduces the government's tax revenues from CCOs.

Executive Summary

The current tax policy settings for local authorities are that:

- A local authority is tax-exempt on income (primarily rates) derived from carrying on activities within its statutory purposes, as per the Local Government Act 2002 (such as water supply).
- A local authority is taxable on income (e.g. rent, management fees, dividends) derived from a CCO.
- A CCO that operates a trading undertaking is taxed to ensure competitive neutrality with the private sector.

The original policy rationale for treating all income a local authority derives from a CCO as taxable was to prevent profit shifting from these taxable entities to exempt local authorities.

Without this provision, income from a CCO could effectively be extracted tax-free by the local authority charging the CCO above-market rental or management fees, which would be deductible to the CCO but not taxable to the local authority due to its tax-exempt status. Despite the above provision, structures can be entered into which allow local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs.

Dividends

Officials consider that the current treatment of taxing dividends derived by a local authority from a wholly-owned CCO is an overreach. This is because a dividend is not a deductible expense of a CCO so there are no profit shifting concerns. Taxing these dividends is an impediment to the movement of capital within a local authority's group to where it can most efficiently be used.

Officials' preferred option to this issue is to exempt these dividends from tax, consistent with similar settings for dividends derived by the Crown from State enterprises, and dividends paid between companies with 100% common ownership.

Officials undertook targeted consultation with the local government sector in early 2021, and this option was supported. Exempting dividends derived by local authorities from wholly-owned CCOs would have no fiscal impact. This is because these dividends are generally fully imputed, and the attached imputation credits would satisfy any tax on the dividends.

Deductions

Current law allows local authorities certain deductions for expenditure not incurred in deriving assessable income (such as corporate gifts and some interest expenses). Access to these deductions allows local authorities to have tax losses despite being largely exempt from tax and these losses can be used to shelter their CCOs from tax. This reduces the government's tax revenues from CCOs.

To address this concern, officials consulted the local government sector on denying loss grouping between a local authority and its CCOs. Officials have accepted feedback from the sector that this option would be an overreach. This is because local authorities can legitimately incur deductible expenditure (such as providing administration services to their CCOs), and, economically, they should be entitled to deduct this expenditure against the taxable income of their CCO group.

After consideration of submissions from the local government sector, officials' preferred option is to prevent local authorities from accessing the corporate gift deduction and limiting interest deductions to the extent they relate to deriving assessable income. Going forward, this will protect the government's tax revenues by reducing the ability for local authorities to transfer the benefit of their tax-exempt status to their CCOs.

Imputation

Current tax rules allow local authorities to use deductions to satisfy their income tax liabilities on dividends from CCOs, without using the full amount of imputation credits attached to those dividends. This results in the local authority having excess imputation credits. The local authority can then convert the excess imputation credits to a tax loss and offset this loss against the taxable income of its CCOs. This is not an intended policy outcome and allows the local authority to shelter its CCOs from tax. Similar to the current rules for deductions, the imputation rules result in reduced tax revenues from CCOs. Officials' preferred option is to prevent a local authority from converting unused imputation credits to a tax loss.

Additionally, local authorities in consolidated groups can access the group's imputation credit account (ICA) and the local authority can credit to the group's ICA imputation credits attached to dividends it derives from a CCO. These credits are then available for reuse by CCOs within the group. This is not an intended policy outcome. Officials' preferred response is to ensure that a credit does not arise to a consolidated group's ICA for imputation credits attached to a dividend derived by a local authority from a CCO.

These imputation proposals were tested with the local government sector in consultation in early 2021 and received support.

Impact on local government sector

The fiscal impact of officials' preferred options is expected to be a revenue increase of $23.8m per year. For context, the surplus for all council groups in the 2020 financial year was $2,322m. Since the tax increases are relatively small, the flow-on economic impacts are expected to be relatively small.

Limitations and Constraints on Analysis

The scope of this project is limited to the immediate integrity risks to local government taxation. Reviewing the taxation of the local government sector as a whole is not currently on the Tax Policy Work Programme and is beyond the scope of this project.

Responsible Manager

Peter Frawley

Policy Lead, Policy and Regulatory Stewardship

Inland Revenue

17 June 2021

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the *Local authority taxation – dividends and deductions* Regulatory Impact Statement prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Statement **partially meets** the quality assurance criteria. This is because the affected stakeholders have not yet had an opportunity to submit on how they would be affected by two of the specific options (denying deductions for donations to donee organisations and denying interest deductions incurred in earning exempt income). Accordingly, the analysis of how these stakeholders would be affected is limited and uncertain.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

The current tax policy settings for local authorities stem from local government reforms of the late 1980s. Broadly speaking, since these reforms the tax settings for local authorities have been as follows:

- A local authority is exempt from tax on income (primarily rates) derived from its core activities (such as water supply).
- A local authority is taxed on income (e.g. rent, management fees and dividends) derived from a council-controlled organisation (CCO) or a port company (trading subsidiaries of a local authority).
- To ensure competitive neutrality with the private sector, CCOs are treated as ordinary companies and are taxed.

The original policy rationale for treating all income a local authority derives from a CCO as taxable was to prevent profit shifting from these taxable entities to exempt local authorities.

Without this provision, income from a CCO could be extracted tax-free by the local authority charging above-market rental or management fees, which would be deductible expenditure for the CCO but not taxable to the local authority due to its tax-exempt status. Despite the above treatment, structures can be entered into which allow local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs.

What is the policy problem or opportunity?

Dividends

Local authorities are taxed on dividends derived from their CCOs. In contrast, an exemption applies for dividends derived by similar entities, such as dividends derived by the Crown from State enterprises, and for dividends paid between New Zealand resident companies where there is 100% common ownership.

Officials consider that the current treatment of taxing dividends derived by a local authority from a wholly-owned CCO is an overreach because it reduces the coherence of the tax rules. The taxation of dividends from CCOs is not consistent with dividends paid to wholly-owned companies nor with the exemption of dividends paid to other exempt entities. There is no tax policy justification for treating these dividends differently. Since a dividend is not a deductible expense of a CCO, there are no profit shifting concerns with treating the dividends as exempt income of the local authority.

Furthermore, the current tax rules are providing an impediment to the most efficient allocation of resources in local government. The local government sector has argued that in addition to improving the coherence of the tax rules, exempting these dividends from tax will allow councils to deliver on their commitments to their communities more efficiently. This would ensure that tax is not an impediment to the movement of surpluses from CCOs to their local authority.

Deductions

Broadly, a local authority should be allowed deductions for any expenditure incurred to the extent to which the expenditure is incurred in deriving assessable income – *not* exempt income.

However, current law allows local authorities certain deductions for expenditure not incurred in deriving assessable income, such as corporate gift deductions and certain interest deductions. We have identified that access to these deductions has allowed local authorities to have tax losses despite being largely exempt from tax, and these losses are being used to shelter their CCOs from tax. This unintentionally reduces the government's tax revenues from CCOs.

Corporate gift deductions

Changes to the corporate gift deduction provision from the 2008-09 income year allowed companies a deduction for charitable donations to donee organisations, only limited by the company's net income. As local authorities are treated as companies under the Income Tax Act 2007, they are able to access this provision.

A significant proportion of corporate gift deductions are claimed by local authorities – they accounted for 38% of all company donations from 2016-17 to 2019-20.

Table 1: Company gift donations from 2016-17 to 2019-20

		2016-17	2017-18	2018-19	2019-20	Total	Four-year average	Four-year average tax effect
Local authorities	Value ($m)	40.7	54.4	55.1	37.7	187.9	47.0	13.2
	% of total	38%	33%	46%	38%	38%	38%	38%
All other companies	Value ($m)	66.5	112.7	64.6	60.4	76.1	76.1	21.3
	% of total	62%	67%	54%	62%	62%	62%	62%
Total value		**107.2**	**167.1**	**119.7**	**98.1**	**492.1**	**123.0**	**34.4**

The corporate gift deduction is intended to encourage companies to redirect part of their otherwise taxable income to charitable, benevolent, philanthropic or cultural purposes. The corporate gift deduction should not apply to primarily exempt entities like local authorities as this results in the tax system subsidising local government funding.

The corporate gift deduction is effectively a tax concession for local government to undertake its legislated purpose (under the Local Government Act 2002) is to promote the social, economic, environmental, and cultural well-being of communities. Consequently, the corporate gift deduction is providing an increase to local government funding that has not been explicitly mandated by central government or considered through the Budget process.

Allowing local authorities to access the corporate gift deduction allows them to transfer the benefit of their exempt status to their taxable CCOs, contrary to the policy intent. This reduces the incidence of tax paid by CCOs.

Interest deductions

A local authority should only be allowed a deduction for interest on money borrowed for the purpose of deriving assessable income. Local authorities are currently allowed deductions for interest on money borrowed to acquire shares in a CCO that is part of the same local authority group. These deductions are not limited to expenditure incurred in deriving assessable income. A local authority can shelter taxable income streams with deductions available for capitalising a CCO that is not carrying on a business to make a profit

Access to deductions for interest expenditure not limited to interest incurred in deriving assessable income is problematic because these deductions can result in local authorities having tax losses. A local authority can then offset these losses against the taxable income of their CCOs. The ability for local authorities to claim these interest deductions results in reduced tax revenues from CCOs.

Imputation

Current tax rules allow some local authorities to satisfy their income tax liabilities on dividends without using the full amount of imputation credits attached to those dividends (e.g. by using corporate gift deductions). This results in the local authority having excess imputation credits. The local authority can then convert the excess imputation credits to a tax loss and offset the tax loss against the net income of its CCO group. This allows the local authority to shelter its CCOs from tax and reduces the government's tax revenues.

The purpose of converting imputation credits to a tax loss was part of the original design of the imputation system, as unused imputation credits are not refundable to the shareholder. The policy intent was to provide a mechanism for taxpayers in tax loss to carry forward the benefit of unused imputation credits to satisfy future income tax liabilities. It was never intended that an exempt shareholder would be able to convert unused imputation credits to a tax loss.

Similar to a final natural person shareholder, local authorities cannot operate an imputation credit account (ICA). However, through the consolidated group rules, local authorities in consolidated groups can access the group's ICA. Consequently, the local authority can credit to the group's ICA imputation credits attached to dividends it derives from a CCO. These credits are then available for reuse by CCOs within the group. This is not an intended policy outcome.

What objectives are sought in relation to the policy problem?

The objective sought in relation to the policy problems is to ensure that the tax rules do not provide opportunities for local authorities to reduce the incidence of tax paid by CCOs, contrary to the policy intent. The policy intent is that CCOs, like State enterprises, are taxed.

Achieving this objective will ensure that the tax rules do not provide opportunities to reduce the government's tax revenues and to ensure that CCOs pay their fair share of tax.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

The following criteria were used to assess the options considered:

- Integrity of the tax system: The primary function of the tax system is to provide revenue to fund government spending priorities.
- Fairness and equity: Taxpayers in similar situations carrying out similar transactions should be subject to similar tax treatment. Like-transactions should have similar or equivalent tax outcomes.
- Impact on local government sector: How does the option affect local government's ability to deliver activities within its statutory purpose? How does the option affect local government funding?
- Fiscal impact: Tax reforms need to be affordable given fiscal constraints.
- Stakeholder support: Is the option supported by the local government sector?

Compliance and administration cost implications have not been considered because there is little difference between the options in terms of impact.

What scope will options be considered within?

The scope of this project is focused on the immediate integrity risks to local government taxation. Options relating to broad sweeping changes to local government taxation are beyond the scope of this project.

What options are being considered?

To analyse the available options, the problem was broken down into three sub-problems: dividends, deductions, and imputation.

Dividends

Option One: Status Quo

Under this option, dividends derived by local authorities from CCOs would continue to be taxed.

Integrity of the tax system: The status quo for dividends poses no integrity risks to local government taxation.

Fairness and equity: Taxing dividends derived by local authorities from CCOs is inconsistent with similar entities, such as the Crown and State enterprises, charities, and wholly-owned companies.

Dividends paid between New Zealand resident companies are exempt where there is 100% common ownership, but local authorities are excluded from this exemption. This exclusion is a legislative overreach. The current setting does not support or harm the original policy intent of preventing profit shifting but weakens the coherence of the tax system by treating similar types of entities differently.

Impact on local government sector: Taxing these dividends is an impediment to the movement of capital within a local authority's group to where it can most efficiently be used.

Taxing dividends does not pose a funding cost for local government. Inland Revenue data shows that dividends derived by local authorities from CCOs in the 2019-20 income year were fully imputed (the dividends have enough imputation credits attached to fully satisfy any tax liability).

Fiscal impact: None. As noted above, dividends derived by local authorities are generally fully imputed. Therefore, taxing or exempting dividends will have no fiscal impact.

Stakeholder support: The local government sector has expressed limited support for maintaining the status quo in regard to dividends.

Option Two – Exempting dividends derived by local authorities from wholly-owned CCOs

This option would exempt dividends derived by local authorities from wholly-owned CCOs, similar to wholly-owned groups of companies.

Integrity of the tax system: Both options for dividends would have the same neutral impact on the integrity of local government taxation.

Fairness and equity: This option would improve the fairness and equity of the local government tax settings. Local authorities and CCOs will be treated similarly to wholly-owned companies with regard to dividends. This would also improve the coherence of local government taxation by removing an unnecessary complication in the tax rules.

Impact on local government sector: Exempting dividends would allow the free movement of surpluses from a CCO to its local authority. This will allow councils to help their communities and deliver their services more efficiently. This option would also ensure that tax is no longer an impediment to possible group restructuring.

Fiscal impact: None. Officials expect dividends derived by local authorities from CCOs to be fully imputed (the dividends have enough imputation credits attached to fully satisfy any tax liability). Taxing or exempting dividends will have no fiscal impact.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021, and the proposal to exempt dividends was broadly supported.

Deductions

Option One – Status Quo

Under this option, local authorities would continue to be allowed certain deductions for expenditure not incurred in deriving assessable income, such as corporate gifts and interest expenses. Local authorities would continue to be able to offset their tax losses against the taxable income of their CCOs.

Integrity of the tax system: The status quo poses significant integrity risks for local government taxation. Allowing local authorities to claim these deductions provides opportunities for local authorities to transfer the benefit of their tax-exempt status to their CCOs. This results in reduced government tax revenues and allows CCOs to not pay their fair share of tax.

Fairness and equity: All local authorities are subject to the same tax rules. However, the current integrity risks are being taken advantage of to varying degrees across the sector. Over the 2016 to 2020 income years, 26 different councils (out of a total of 78 local authorities) claimed corporate gift deductions. Three councils accounted for 80% of the total corporate gift deductions claimed by local authorities. This represents 30% of all corporate gift deductions claimed by companies.

The corporate gift deduction represents a cost to all taxpayers but is currently only being used by some local authorities.

These deductions allow local authorities to reduce the incidence of tax paid by CCOs, which is unfair.

Impact on local government sector: The current tax rules are providing unintentional tax subsidies to local government.

As noted above, the current integrity risks are being taken advantage of to varying degrees across the sector. Due to limited data on which interest deductions are being claimed by local authorities, officials are unable to determine the exact overall impact of the current tax rules across the local government sector.

The availability of these deductions allows local authorities to shelter their CCOs from tax. Since CCOs would have less tax to pay, this means they are able to pay larger dividends to their local authorities. That is, the current rules increase local government funding by facilitating larger dividends to be paid from CCOs to local authorities.

Fiscal impact: Allowing local authorities to continue to claim the corporate gift deduction has a fiscal impact. The yearly average tax impact of charitable donations by local authorities over the 2016-17 to 2019-20 income years is $13.2m. This represents lost tax revenue for central government and an increase to local government funding.

Stakeholder support: The local government sector strongly supported maintaining the status quo over denying loss grouping. Option Three, denying certain deductions, was developed by officials based on feedback from submitters on Option Two and has not been tested with stakeholders.

Option Two – Loss grouping

This option would prevent local authorities from grouping their tax losses against the taxable income of their CCOs.

Integrity of the tax system: Preventing loss grouping between a local authority and its CCOs would mean that a local authority could not use tax losses arising from deductions or excess imputation credits to shelter its CCOs from tax. This would prevent the current integrity risks from eroding government tax revenues.

Fairness and equity: Although local authorities are generally exempt, they do not sit fully outside the tax base. A local authority should be entitled to offset any losses arising from deductions for expenditure incurred in deriving assessable income against its CCOs.

Denying loss grouping would be an overreach and would treat local authorities more harshly than other companies.

Impact on local government sector: Preventing loss grouping between a local authority and its CCOs would mean that a local authority could not offset *any* tax losses against its CCOs' income. This option would lead to inefficiencies in local government, as it would disincentivise councils from providing administrative support and other functions to their CCOs, as they would be unable to offset any losses arising from the underlying expenditure. Any losses arising from this expenditure would be stranded in local authorities.

This option would negatively impact local government funding by leading to CCOs paying smaller dividends to their local authorities. This is because denying loss grouping will mean that CCOs will have higher tax liabilities since local authorities will not be able to offset any of their losses against the taxable income of their CCOs.

Fiscal impact: It is expected that the fiscal impact of the loss grouping proposal would generate more tax revenue than Option Three. This is because it would prevent local authorities from grouping any losses with its CCOs, as opposed to just focusing on certain deductions as in Option Three. The exact fiscal impact of Option Two was not quantified.

Stakeholder support: In early 2021 the local government sector provided strong feedback against the proposal to deny loss grouping between local authorities and CCOs. The sector argued that local authorities can incur genuinely deductible expenditure and should be entitled to offset these deductions against taxable income in its CCO group.

Option Three – Denying deductions (corporate gift deduction and certain interest deductions)

This option would prevent local authorities from claiming deductions for charitable donations to donee organisations and would limit access to interest deductions to expenditure incurred in deriving assessable income. This option was developed by officials following feedback by the local government sector on Option Two above.

Integrity of the tax system: This option would result in local authorities not being able to claim deductions for expenditure incurred in funding CCOs that do not have a profit-making purpose.

This option would limit the ability of local authorities to shelter their CCOs from tax. This will ensure that CCOs pay their fair share of tax and will help maintain the government's tax revenues.

Fairness and equity: Over the 2016 to 2020 income years, 26 different councils (out of a total of 78 local authorities) claimed corporate gift deductions. Three councils accounted for 80% of the total corporate gift deductions claimed by local authorities. This represents 30% of all corporate gift deductions claimed by companies. The corporate gift deduction is an indirect cost to all taxpayers but is being claimed by a minority of councils.

Access to these deductions allow local authorities to reduce the incidence of tax paid by CCOs. This option would improve the fairness of the tax settings for taxpayers by reducing the ability to shelter CCOs from tax.

Impact on local government: The impact of this option will be uneven on the local government sector since these deductions are being claimed to varying degrees across the sector.

As noted above, over the 2016 to 2020 income years, only 26 councils claimed the corporate gift deduction. This provision is benefiting the funding flows of a minority of councils despite their largely tax-exempt status. Most councils would not be affected by preventing local authorities from claiming this deduction.

This option will result in increased costs for councils to the extent that they are receiving a benefit from these deductions. Due to limited data on interest deductions, officials are unable to estimate the exact impact of this option on local government. Reducing the ability of these local authorities to shelter their CCOs from tax will result in lower dividends being paid by CCOs to their local authorities. This is because these CCOs will have greater tax liabilities.

The cost to local government of denying access to the corporate gift deduction is expected to be $23.8m per year. For context, the surplus for all council groups in the 2020 financial year was $2,322m. Since the impact of this proposal is relatively small, the flow-on economic impacts are expected to be relatively small.

Fiscal impact: The fiscal impact of preventing local authorities from accessing the corporate gift deduction is expected to raise approximately $13.2 million per year. Inland Revenue has limited data on the breakdown of which specific interest deductions are being claimed by local authorities and is unable to quantify the full fiscal impact of the interest deduction proposals.

Stakeholder support: In consultation on the loss grouping proposal, some submitters suggested focusing on the specific deductions that are considered inappropriate, rather than denying loss grouping outright. Submitters argued that denying loss grouping would be an overreach, as local authorities can incur genuinely deductible expenditure.

Officials accepted these arguments from the sector and developed the narrower proposal to limit certain deductions. Officials expect that the local government sector will not support this proposal but will prefer it to the loss grouping proposal.

Officials expect that donee organisations would oppose this proposal, as it reduces the incentives for councils to make donations. Donee organisations were not consulted on this proposal, as this proposal was developed after consultation was undertaken with the local government sector. During consultation on Option Two, officials received feedback from the sector that although preventing access to the corporate gift deduction would increase the cost of these donations, it was unlikely to lead to councils not making them. This is because councils have a commitment to improve the social, economic, environmental, and cultural well-being of their communities, and donee organisations often play a key role in fulfilling these objectives.

Imputation

Option One – Status Quo

Under current settings, local authorities can convert excess imputation credits to a tax loss. Local authorities in consolidated groups can access the group's imputation credit account (ICA) and the local authority can credit to the group's ICA all imputation credits attached to dividends it derives from a CCO.

Integrity of the tax system: The current imputation settings pose significant integrity risks to the tax system. By maintaining current settings, local authorities will be incentivised to satisfy the tax liability on dividends with available deductions and convert the excess imputation credits to tax losses. This will allow local authorities to transfer the benefit of their tax-exempt status by sheltering their CCOs from tax, resulting in lower tax revenues.

Fairness and equity: The ability to convert excess imputation credits to a loss is inconsistent with other generally exempt entities (such as charities).

Local authorities cannot maintain their own ICA. However, a council's consolidated group can benefit via the group's consolidated group account. The status quo is unfair for councils that are not part of a consolidated group, as they are not able to take advantage of the same benefits.

Impact on local government: The current settings allow a local authority to convert excess imputation credits to a loss and use this loss to satisfy a future tax liability of the local authority, or to offset against the income of the CCO group.

Local authorities are prohibited from maintaining an imputation credit account in their own right. The current imputation rules provide an economic benefit to councils in consolidated groups. CCOs in a consolidated group can use imputation credits that have been received by a local authority and credit to the group's imputation credit account. This can result in recycling of imputation credits.

The flow-on effect of the current imputation rules is that CCOs can pay larger dividends to councils because they have less tax to pay.

Fiscal impact: In the 2020 income year, the conversion of excess imputation credits by local authorities to tax losses had a tax effect of approximately $10.6m.

Although maintaining the status quo will have no direct fiscal impact, imputation credit conversion in this context can be considered as lost revenue for the government and gained funding for local government.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021. The sector did not argue to retain the status quo in regard to imputation. The proposals outlined in Option Two received support.

Option Two – Preventing excess imputation credit conversion to tax losses

This option would prevent local authorities from converting excess imputation credits to tax losses and would ensure that a credit does not arise to a consolidated group's imputation credit account for imputation credits attached to dividends derived by a local authority.

Integrity of the tax system: This option reduces significant integrity risks in local government tax settings. It largely reduces the ability of local authorities to transfer the benefit of their tax-exempt status to their CCOs. This option would help maintain the government's tax revenues.

Fairness and equity: Preventing local authorities from converting excess imputation credits to a loss ensures that local authorities are treated similarly to other generally exempt entities (such as charities).

Ensuring that a credit does not arise to a consolidated group's imputation credit account for imputation credits attached to dividends derived by a local authority would improve the fairness of the tax rules by ensuring that local authorities have the same imputation treatment regardless of whether they are in a consolidated group or not.

Impact on local government: This option would have an uneven funding impact on councils. Inland Revenue data shows that 44 councils converted excess imputation credits to losses in the 2020 income year. 10 councils accounted for 91% of the total amount converted. This option will be a funding impact for councils to the extent that they were taking advantage of these rules.

Preventing local authorities from converting excess imputation credits to losses would reduce the ability for councils to reduce the taxable income of their CCOs. This will likely lead to smaller dividends from CCOs to local authorities.

The cost of this proposal to local government is expected to be $10.6m per year. For context, the surplus for all council groups in the 2020 financial year was $2,322m. Since the impact of this proposal is relatively small, the flow-on economic impacts are expected to be relatively small.

Fiscal impact: In the 2020 income year, the conversion of excess imputation credits by local authorities to tax losses had a tax effect of approximately $10.6m. This option would be a revenue gain for the government and would reduce the amount of income of local government.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021. The sector did not have strong views on the imputation problem, but these proposals received support.

Dividends: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Exempting dividends derived from wholly-owned CCOs
Integrity of the tax system	0	0 No impact on the integrity of the tax system.
Fairness and equity	0 The status quo reduces the coherence of the tax system	+ This option would improve fairness and equity by allowing local authorities to access the inter-corporate dividend exclusion, similar to wholly-owned companies.
Impact on local government	0 The status quo is unfair as it treats similar entities differently.	+ This would ensure that tax is no longer an impediment for the movement of surpluses from a wholly-owned CCO to its local authority.
Fiscal cost	0	0 No fiscal impact.
Stakeholder support	0	+ The local government sector supports exempting dividends.
Overall assessment	0	+ Officials prefer this option to the status quo as it improves the fairness, equity, and coherence of the tax rules and it is supported by the local government sector.

Key for qualitative judgements:

++ much better than doing nothing/the status quo

\+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

\- worse than doing nothing/the status quo

\- - much worse than doing nothing/the status quo

Deductions: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Denying loss grouping	Option Three: Denying certain deductions
Integrity of the tax system	0	++ This option would prevent the current integrity risks from eroding tax revenues.	++ This option would prevent the current integrity risks from reducing tax revenues.
Fairness and equity	0	- Denying loss grouping would prevent local authorities from grouping *any* losses. This would be unfair considering they can incur deductible expenditure in deriving assessable income in their CCOs	+ This option would improve the fairness of the tax settings for taxpayers by reducing the ability for local authorities to shelter CCOs from tax.
Impact on local government	0	- - Preventing local authorities from grouping any losses would increase the costs of most councils carrying on their functions and services.	- Preventing local authorities from accessing the corporate gift deduction and limiting certain interest deductions would increase the costs of some councils carrying on their functions and services.
Fiscal impact	0	+ This option would raise tax revenues for central government.	+ The option would raise tax revenues for central government.
Stakeholder support	0	- - The local government sector strongly opposed denying loss grouping.	- Officials expect that this option would not be supported by the sector but would be preferred to Option Two.
Overall assessment	0	0 This option achieves the primary objectives of limiting erosion of tax revenues but comes with significant adverse impacts to fairness, equity, and local government.	+ This option resolves the integrity risks to tax revenues by focusing on the inappropriate deductions.

Imputation: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Preventing local authorities from converting excess imputation credits to losses
Integrity of the tax system	0	++ This option reduces significant integrity risks for local government taxation.
Fairness and equity	0	+ This option would treat councils similarly to other exempt entities and would ensure local authorities receive the same tax treatment for imputation regardless of whether they are in a consolidated group or not.
Impact on local government	0	- This option would have a funding impact on local government by likely resulting in smaller dividends from CCOs to councils.
Fiscal impact	0	+ This option would raise tax revenues for central government.
Stakeholder support	0	+ The sector supported the proposed changes to imputation during consultation in early 2021.
Overall assessment	0	+ This option achieves the primary objective of resolving integrity risks with local government taxation and maintaining tax revenues.

Conclusion: What options are likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Officials consider that the following options will best address the problem:

- **Dividends**: Option Two – Exempting dividends derived by local authorities from wholly-owned CCOs
- **Deductions**: Option Three – Denying certain deductions
- **Imputation**: Option Two – Preventing local authorities from converting excess imputation credits to a tax loss.

What are the marginal costs and benefits of the options?

Affected groups *(identify)*	**Comment** *nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred options compared to taking no action			
Regulated groups: local authorities, CCOs	The proposed changes will result in a funding impact for local authorities.	Approx. $23.8m per year	Medium
Regulator: Inland Revenue	The administration costs for Inland Revenue are expected to be negligible.	Very low	High
Other groups: donee organisations	The proposed changes may result in fewer or smaller donations from local authorities to donee organisations. Although the changes will remove a tax concession for making these donations, officials consider that councils will likely continue to donate because they have a commitment to improve the social, economic, environmental, and cultural well-being of their communities, and donee organisations often play a key role in fulfilling these objectives.	Low	Medium
Total monetised costs	Funding impact for local government	Approx. $23.8m per year	Medium
Non-monetised costs	n/a	n/a	n/a
Additional benefits of the preferred options compared to taking no action			
Regulated groups: local authorities, CCOs	n/a	n/a	n/a
Regulator: Inland Revenue	n/a	n/a	n/a
Other groups: central Government	Increased tax revenue for the Government	Revenue gain of approx. $23.8 per year	Medium
Total monetised benefits	Increased tax revenue	Approx. $23.8m per year	Medium
Non-monetised benefits	n/a	n/a	n/a

Section 3: Delivering an option

How will the new arrangements be implemented?

If approved by Cabinet, amendments to the Income Tax Act 2007 will be included in the next omnibus tax bill, scheduled for introduction in August 2021. The changes will apply from the start of the 2022-23 income year.

Inland Revenue will be responsible for administering the changes. This will have no impact on Inland Revenue's systems and will largely involve communicating the changes with the local government sector and rewording some guides and forms. This will have negligible ongoing administration costs.

Officials will provide guidance on the changes to local government taxation in a *Tax Information Bulletin* item.

How will the new arrangements be monitored, evaluated, and reviewed?

Inland Revenue policy officials will work with operational Inland Revenue officials to monitor the implementation and any ongoing impacts to confirm that they match the policy objectives.

Policy officials will also analyse Inland Revenue data from the 2022-23 income year to monitor whether the measures have met the policy objectives of improving the integrity of local government taxation.

Inland Revenue will undertake post-implementation consultation engagement with the local government sector and its tax advisors, pursuant to the Generic Tax Policy Process (GTPP) and the Tax Policy Work Programme, to ensure the rules are working as intended.

Inland Revenue has strong networks in the tax community (including tax advisors to the local government sector) that will provide opportunities for stakeholders to raise any concerns as they arise.

Impact Summary: New Zealand Memorial Museum Trust – Le Quesnoy: tax benefits for monetary donations

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Quality of data used for impact analysis In developing this Regulatory Impact Assessment (RIA), Inland Revenue used information provided by the New Zealand Memorial Museum Trust – Le Quesnoy (the Trust) in an in-confidence business case, and subsequent telephone and email contact. External information about tourism patterns in France were used to verify or test some of the assumptions underpinning the business case. Not all information in the business case could be verified, however, and the level of donor support beyond 2021–22 cannot be readily determined. **Options considered** This RIA considers whether the Trust should be granted overseas donee status. The decision is binary, and as such, this RIA considers only two options. There are other options that would provide direct Government assistance to the Trust, such as grants. The Trust, however, has signalled that it is not seeking such assistance at this time. **Consultation** Consultation on this issue was in the form of email and telephone conversations between Government agencies, the Trust's Chair and the Trust's advisor. Private sector consultation was not carried out. **Sensitivity to tax benefits** Inland Revenue has been informed by the Trust that its potential donors are sensitive to the tax effects of their donations in their decision-making whether to donate. Inland Revenue does not have information to assess the effect of tax benefits on donor decision to donate.

Responsible Manager (signature and date):
Brandon Sloan Policy and Strategy Inland Revenue 26 July 2018

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This RIA considers whether a New Zealand charity, the New Zealand Memorial Museum Trust – Le Quesnoy (pronounced le-ken-wah) should be granted overseas donee status by Cabinet.

The main objective behind the policy underpinning overseas donee status is to indirectly support New Zealand's overseas development aid programme by providing tax benefits, such as tax credits or tax deductions, under the Income Tax Act 2007, to a specified class of charity whose purposes are largely directed at the relief of poverty, or improving education or economic outcomes in developing countries, as set out in criteria set out by Cabinet in 1978. The Trust's purposes fall outside the main objective, and its approval would be an exception to the current policy framework.

A decision to grant the Trust overseas donee status could therefore create a precedent for tax purposes, and raise expectations that Cabinet will look more favourably on future requests from charities whose purposes are not directed at overseas development.

New Zealand Memorial Museum Trust – Le Quesnoy

The Trust is proposing to create a memorial museum (the Museum) in Le Quesnoy, France. The Trust is currently raising funds to support the project and wants monetary donations to the Trust to be eligible for tax benefits, so that it can further its objects and tell the story of Le Quesnoy as the cornerstone of the New Zealand First World War military story.

Specifically, the Trust's purposes are:

- To own and operate a Museum in Le Quesnoy, France, that will provide information and learning resources to visitors, and raise awareness of New Zealand's participation in and contribution to the First World War; and
- Develop a programme of cultural and educational exchanges between New Zealand and Le Quesnoy, France, for all people in New Zealand and in France.

The trustee's vision for the Trust is to establish a permanent war memorial in Le Quesnoy, in the form of a Museum, in remembrance of the New Zealanders who fought in France. The proposed Museum would create a complex with functional exhibition space and include self-catering accommodation facilities, which the Trust believes by 2021 will fund the Museum's ongoing operations. Inland Revenue notes that the project is likely to support economic development (tourism) in the region by adding accommodation capacity to the town.

The liberation of Le Quesnoy on 4 November 1918 was New Zealand's last major action during the First World War and, as such, has been viewed as a significant milestone in our military history. The liberation was achieved without the loss of any civilian lives. The town of Le Quesnoy maintains links with New Zealand, and a special connection exists between New Zealand and the people of Le Quesnoy.

Le Quesnoy is located in Northern France (12 km from the Belgium boarder) and its current population is approximately 5,000. Le Quesnoy has fairly limited local amenities (shopping, accommodation and entertainment). The Mayor of Le Quesnoy supports and is an advocate of, the development of the Museum and accommodation project. The Museum is one of a number of economic development activities being carried out in the region.

The Trust is not part of any Government initiative relating to the First World War Centenary Programme (WW100). The project is a private endeavour.

Problem definition

The Trust's purposes are outside New Zealand and its donations do not currently qualify for tax benefits. Further, the Trust's purposes fall outside the normal framework used by Cabinet to grant overseas donee status (see **Overseas donee status – Cabinet's approval criteria** below). The Trust is therefore seeking to be granted overseas donee status as an exceptional case.

As with all overseas donee status approvals, legislation is needed to specify that the Trust is a donee organisation (with overseas donee status) for the purposes of the Income Tax Act 2007 and allow donations to qualify for tax benefits (such as the donations tax credit or tax deductions – see **Tax benefits for monetary donations to charities**).

The trustees want to advise potential donors about the Government's decision to facilitate fundraising well before the commemorations at Le Quesnoy on 4 November 2018.

A decision to grant overseas donee status to the Trust would result in the Government indirectly committing funds (through reduced tax revenue) to the Le Quesnoy project, albeit on a successful efforts basis given that the support ultimately depends on the trustees' success in fundraising.

Tax policy

Tax benefits for monetary donations to charities

Since 1962, the tax system has provided tax benefits for monetary donations to New Zealand charities (including benevolent, philanthropic, or cultural organisations) whose purposes are largely limited to New Zealand.

Under current tax policy settings, the tax benefits include:

- the donation tax credit of $33^1/_3$% of the value of any monetary donations made by a New Zealand resident individual taxpayer, capped to the amount of their taxable income; and
- income tax deductions if the monetary donation is from a New Zealand resident company or Māori authority, capped to the amount of their net income.

Eligibility for the tax benefits is subject to certain statutory limitations on the charities' purposes and application of funds, which must relate "wholly or mainly" to purposes in New Zealand.[1] Generally, the availability of tax benefits for donations is limited to charities with New Zealand purposes only. New Zealand charities that support activities overseas and want their donors to be eligible for tax benefits (in particular, the donation tax credit) must be specifically listed in the Income Tax Act 2007 (overseas donee status).

Broadly, governments seek to promote charitable giving:

[1] There are a number of interpretations of the phrase "wholly or mainly". Inland Revenue is currently analysing submissions on a draft interpretation statement PUB00295 Income Tax: Donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand.

- to further social objectives,
- for the wider benefits to society (externalities), which may be over and above the value of the benefit provided via the tax system, and
- because donations can be effective indicators of when extra goods and services should be provided in market conditions that might otherwise not exist.

Overseas donee status – Cabinet's approval criteria

In 1978, Cabinet refined the policy position set in 1962,[2] by setting the parameters of overseas charitable activities that may be supported by the tax system:

The basic criteria for adding an organisation to the list of approved "overseas" charities:

(i) the funds of the charity should be principally applied towards:

the relief of poverty, hunger, sickness or the ravages of war or natural disaster; or

the economy of developing countries; or*

raising the educational standards of a developing country;*

(ii) charities formed for the principal purpose of fostering or administering any religion, cult or political creed should not qualify;

** developing countries recognised by the United Nations.*

[CM 78/14/7 refers]

The criteria set out in CM 78/14/7 have, except in a few instances, been applied consistently in Cabinet decision-making over the last forty years. Currently 138 charities and other organisations are listed in the Income Tax Act and have overseas donee status. All but four of the charities named on the list meet Cabinet's approval criteria (CM 78/14/7) and are engaged in overseas development. Of the four organisations that do not meet the criteria and granted overseas donee status, three are Government initiatives and have direct Government oversight or financial support. The other organisation is Amnesty International, a large internationally recognised charity with significant New Zealand donor support.

The eligible purposes set out in the criteria are aligned with the government's overseas development objectives (disaster relief, provision of humanitarian aid, and assisting developing countries). The eligible purposes are narrower than the common-law meaning of "charitable purpose" and the legislative framework in the Charities Act 2005. Assessing donee status, including overseas donee status, remains the responsibility of Inland Revenue because of the tax benefits attached to monetary donations. The process does not overlap the work of the Department of Internal Affairs – Charities Services.

[2] At the time, four charities with overseas purposes were specifically named as donee organisations for income tax purposes, and the government acknowledged that charities could be added to the list of names from time to time as comparable cases arise. The four charities were: the Red Cross Society Incorporated, the Council of Organisations for Relief Services Overseas (CORSO), and two leprosy missions. Source: 1962 Budget statement.

Decisions to grant overseas donee status are implemented using legislation.

In 2016, advice to Inland Revenue from the Legislative Design and Advisory Committee confirmed that the use of legislation to implement decisions to give overseas donee status was appropriate, given that approvals are a special case, because:

- determining overseas donee status has (or might have) a political and moral dimension; and
- it ensures decision-making transparency, and promotes a bipartisan approach.

Analysing requests for overseas donee status

Inland Revenue analyses a number of factors when considering a charity's request to be granted overseas donee status. The purpose of the analysis, consistent with CM 78/14/7 and CBC Min (09) 12/2,[3] is to establish whether the charity is capable of meeting its purposes and is accountable for the funds it collects by:

1. reviewing the charity's governing documents (constitution and trust deed) to ensure the activities and purposes are consistent with Cabinet's criteria,
2. requiring the purposes stated in the charity's governing documents to be entirely within the scope of paragraph (i) of the Cabinet criteria and that no personal pecuniary profit can be derived,
3. looking at the clauses governing the nature and extent of the trustees' discretionary powers, the winding-up clause, and the trustees' ability to amend the governing documents,
4. looking at the charity's past, current, and proposed activities,
5. requesting that the trustees provide Inland Revenue with the charity's financial statements,
6. considering the trustees' degree of control over the application of the charity's funds overseas, and procedures in place to ensure accountability for funds,
7. considering the planning, monitoring, and evaluation processes used by the trustees in respect of the application of the charity's funds, including how recipients use the funds, as well as the processes used to select beneficiaries and/or projects to support,
8. asking whether the charity has a legal presence in New Zealand and if it has registered under the Charities Act 2005,
9. considering each request on the basis of other generic tax policy objectives, such as fiscal implications (including risk to the New Zealand tax base), consistency with other current Government policy objectives, and the precedent effect, and
10. consulting with other Government agencies such as the Treasury and the Department of Internal Affairs – Charities Services. The Ministry of Foreign Affairs and Trade is also consulted to identify if any concerns exist with the charity or sensitivities with the countries in which the charity operates. Inland Revenue also uses the New Zealand Police's vetting service in connection with the charity's trustees or directors.

[3] In November 2009, Cabinet endorsed the processes used by tax policy officials to analyse charities requesting overseas donee status, resulting in the release of *Guidelines for using the Cabinet Criteria for Overseas Donee Status*.

In this particular case, points 1 and 2 were ignored, as the purposes of the Trust fall outside the scope of the Cabinet criteria. However, the Trust's deed has the required constraints prohibiting the trustees from deriving any personal pecuniary profit from the Trust's activities, over and above what would be expected from an arm's length transaction.

2.2 Who is affected and how?

The Trust is currently raising funds to support the project and wants monetary donations to the Trust to be eligible for tax benefits. The trustees have informed Inland Revenue that its potential donors are tax sensitive, and may not make donations to the Trust if they do not give rise to tax benefits.

2.3 Are there any constraints on the scope for decision making?

For present purposes, the Trust wants to influence donor decision-making by offering tax benefits for the monetary donations it receives. This has narrowed the options considered in this RIA to those that concern the tax system.

Alternative Government responses, such as financially supporting the Trust via grants or alternative co-governance structures (public/private partnerships) have not been considered. The Trust is not at this time wanting direct Government support.

This analysis therefore does not consider the wider issue of whether the New Zealand Government should directly support (financially or otherwise) the creation of a war memorial museum in France.

Section 3: Options identification

3.1 What options have been considered?

Acknowledging that the Trust is seeking overseas donee status to support its fundraising efforts, the following criteria have been applied to assess the options:

- *Effectiveness*: Does the option incentivise donations to the Trust?
- *Sustainability*: Does the option maintain the integrity of the tax system and operate coherently with the frameworks used?
- *Fairness and equity*: Is the option consistent with previous decisions regarding granting overseas donee status?
- *Tax administration*: Does the option introduce complexity in tax administration?

Tax compliance implications have not been considered because there is little difference between the options in terms of impact on the Trust.

From the Trust's perspective, the main criterion is effectiveness in terms of encouraging donations to the Trust. From Inland Revenue's perspective, the main criterion is sustainability, that is, the option should be consistent with current tax frameworks.

As entitlement to tax benefits for monetary donations to charities with overseas purposes is prescribed by legislation, non-legislative responses, apart from the status quo, are not viable.

Two options have been considered:

- the Trust's request for overseas donee status is declined (status quo option); or
- the Trust's request for overseas donee status is accepted (exception option)

Option one: Decline the Trust's request for overseas donee status (maintain the status quo)

Under the status quo, monetary donations to the Trust would be ineligible for tax benefits. This would affect the Trust's ability to fundraise and, among other things affect the completion of the proposed Museum. As such, this option does not meet the effectiveness criterion. It is noted that, irrespective of the Trust being granted overseas donee status, other environmental factors, such as the location of Le Quesnoy, and the absence of tourism infrastructure in the area, may have a more direct impact on the viability of the project promoted by the Trust.

Declining the Trust's request for overseas donee status meets the sustainability and fairness and equity criteria because:

- the Trust's purposes are outside the scope of Cabinet's approval criteria (CM 78/14/7 refers), and
- declining the request would be consistent with earlier Cabinet decisions to decline overseas donee status for charities that do not meet the criteria in CM 78/14/7.

There are wider issues to do with whether New Zealand should have a war memorial museum in France to commemorate the military service of New Zealand during the First and Second World Wars, but this question is beyond the immediate scope of this RIA.

Declining the Trust's request for overseas donee status does not impact on Inland Revenue's administration of the tax system and confirms existing policy frameworks and practices.

Feedback from government agencies who were consulted as part of Inland Revenue's analysis of the Trust supported its request for overseas donee status being declined.

Option two: Grant the Trust's request for overseas donee status

Under option two, monetary donations to the Trust would be eligible for tax benefits. This meets the effectiveness criterion. Ultimately, however, the benefit accruing to the Trust depends on its fundraising efforts, as this option only provides indirect Government support to the Trust's project on a successful efforts basis. The trustees report that about $6 million of donations would be made in the current tax year (2018–19) if the Trust received overseas donee status. The trustees estimate that $15 million is needed to complete the complex to a point where it can open to the public.

Option two does not meet the other criteria because:

- From a sustainability process granting the Trust overseas donee status would create a precedent. It could raise expectations that Cabinet will look favourably on future requests from charities whose purposes are not directed at overseas development.
- From a fairness and equity perspective, granting the Trust overseas donee status would be inconsistent with previous historical Cabinet decisions that have declined charities with, for example, religious purposes, plant conservation purposes, animal welfare purposes, and animal conservation purposes.

- From a tax administration perspective, granting the Trust overseas donee status may introduce uncertainty about the decision-making process for granting overseas donee status. This could affect the cohesiveness of the approval process and make it more difficult to manage charities' expectations about being granted overseas donee status. Tax policy concerns aside, granting the Trust overseas donee status does not create any implementation concerns, provided that legislation implementing the approval is enacted before 31 March 2019. There are no implications for Inland Revenue's Business Transformation Programme.

3.2 Which of these options is the proposed approach?

Inland Revenue's preferred option is that the Trust's request is declined for the following reasons:

Concerns over visitor assumptions and financial viability

The information and assumptions supporting the project suggest that the viability of the project, in the absence of an additional direct long-term financial commitment from the Government, is doubtful, if

- forecasting donor support does not materialise,
- expected visitor numbers to the Museum and the number of those who stay at the accommodation complex are not realised.

The business case notes that the Museum will be a loss-making exercise and relies on projected revenue from the accommodation complex to produce a surplus.

Le Quesnoy is in Northern France (12 km from the Belgium boarder) and the current population is approximately 5,000. There are fairly limited local amenities (shopping, accommodation and entertainment) in Le Quesnoy. Research to develop Ngā Tapuwae (a Government WW100 initiative, which developed a trail of key First World War sites relating to New Zealand, which includes Le Quesnoy) noted that many New Zealanders who visit the battlefields in France use Arras, which has well-developed tourist infrastructure, as a base to visit Le Quesnoy.

Revenue assumptions regarding visitors to the Museum and visitor occupation (30,000 per annum, from an unofficial estimated annual day-tripper visitor base of 100,000)[4] appear high, relative to official visitor numbers in the region and to more well-known and established memorials. For example, in 2017, the Tourism Office in Le Quesnoy had 5,205 in-person visitor centre enquiries and 10,000 visitors in its Leisure park, while official statistics record:[5]

- Mémorial Canadien, Vimy[6] (opened 2005); 121,000+ visits,
- La Carrière Wellington, Arras (opened in 2008);[7] 65,000+ visits, and

4 The Trust notes that a planned cycle way connecting the local towns in the area may increase tourist numbers.

5 Source: Hauts-de-France Tourism Council 2017/18.

6 The Canadian National Vimy Memorial has iconic national status for Canadians.

7 A local French funded project, the Wellington Quarry in Arras, is an underground museum founded to the memory of the British Army and Dominion Forces and tells the story of the New Zealand Tunneling Company. The community project charges €7 (euros), but this is situated in a big city and has an attraction beyond battlefield visitors. Arras is typically used as a base from which tourists visit other war memorials in the region, including Le Quesnoy.

- Australian Memorial at Fromelles (opened in 1998); 32,000 visits.

The Trust is proposing to charge €6 (euros) entry to the Museum. Comparable memorials are free – such as the Canadian National Vimy Memorial, and the St John Monash Centre, Australian National Memorial, Villers-Bretonneux (the latter is cutting edge in terms of museum design and content).

Concerns about whether the Trust can meet its charitable purposes

Inland Revenue notes that detailed provisions have not been made for the cost of acquiring artefacts or curating the Museum. Artefacts that are over 100 years old are subject to an approval process under the Protected Objects Act 1975 if they are leaving New Zealand.

The Trust has not developed plans or policies to implement the cultural exchange programme that underpinned its registration as a charity under the Charities Act 2005. The Trust has explained that cultural exchanges are not a priority at this time.

Purposes of the Trust are inconsistent with current policy frameworks

The project being advanced by the Trust is a private endeavour, and although it is not seeking direct Government assistance, it wants indirect assistance in the form of tax benefits for monetary donations. To achieve this aim, the Trust is asking to be granted overseas donee status as an exceptional case.

Granting overseas donee status is a Government decision, and it has in four instances granted overseas donee status to organisations that do not meet the normal Cabinet criteria to further wider government objectives. Typically, organisations granted overseas donee status in these circumstances are either directly funded by the Government or the Government has governance oversight. The only other exception is Amnesty International, which was granted overseas donee status in 1983 on the grounds that it was widely respected, recognised worldwide and was strongly supported in New Zealand. The last exception was made in 1987 for the Hillary Commission for Recreation and Sport, a public authority.

Neither the direct Government support principle nor all the grounds applying to Amnesty International are present in support of the Trust's request that it be granted overseas donee status.

Conclusion

Inland Revenue considers the Trust should not be given overseas donee status because:

- the Trust's purposes are outside the normal policy parameters for approving overseas donee status, and
- the future viability of the Trust, at this point in time, is far from certain.

Neither option has areas of incompatibility with the Government's expectation for the design of regulatory systems.

Section 4: Impact Analysis: granting overseas donee status to the New Zealand Memorial Museum Trust – Le Quesnoy

4.1 Summary table of costs and benefits
To make the impact analysis in this section more meaningful, it has been prepared illustrating the costs and benefits if the New Zealand Memorial Museum Trust – Le Quesnoy was granted overseas donee status. The cost and benefits are therefore those that may arise when contrasted against the status quo (no overseas donee status).

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs if the Trust is granted overseas donee status, compared to taking no action		
Regulated parties	On-going compliance costs of the Trust's preferred option are comparable to the status quo.	Low
Regulators	Administration costs increase in response to uncertainty in the decision-making process for overseas donee status.	Medium
Wider government	It is possible that granting the Trust overseas donee status may raise the expectations of the Trust and the town of Le Quesnoy, that the New Zealand Government may contribute further additional funds (either directly or indirectly) to the project to ensure the Trust's continued operations.	Unknown
Other parties	None	N/A
Total Monetised Cost		$5 million + reduction in Government revenue over the forecast period 2018 to 2021.
Non-monetised costs		*Medium*
Expected benefits if the Trust is granted overseas donee status, compared to taking no action		
Regulated parties	Improves the Trust's chances of raising the required $15 million to complete the Memorial Museum project.	Medium
Regulators	None	N/A
Wider government	None	N/A
Other parties	Donors are eligible for monetary donations made to the Trust.	Estimated tax benefit to donors is $5 million +.

Total Monetised Benefit		$5 million + reduction in Government revenue over the forecast period 2018 to 2021.
Non-monetised benefits		*Medium*

4.2 What other impacts is this approach likely to have?

Inland Revenue notes that, at this point of time, there are too many unknowns regarding the proposed operation of the Museum and accommodation complex, and it is hard to assess the viability of the proposal. A potential risk arising from the project promoted by the Trust is that it may put pressure on the Government to provide additional and ongoing Government contributions (either direct or indirect) to ensure the Trust's long-term and continued operations.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

The Treasury, the Ministry of Foreign Affairs and Trade, the Ministry for Culture and Heritage, and the New Zealand Defence Force were consulted in the preparation of the attached Cabinet paper. Comments from agencies generally questioned the need for the war memorial museum as promoted by the Trust (there are a number of existing memorials commemorating New Zealand's service during the First World War, including a memorial wall at Le Quesnoy). The Department of Internal Affairs – Charities Services was also consulted, and the New Zealand Police's vetting service was used for the trustees of the Trust. The Department of the Prime Minister and Cabinet were informed.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

Legislative change to the Income Tax Act 2007 is necessary to implement option two. If the Trust is granted overseas donee status, a Supplementary Order Paper to the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill will be prepared. The changes would apply to monetary donations made on and after 1 April 2018.

The Trust has not highlighted any concerns regarding compliance with the Inland Revenue Acts if is granted overseas donee status.

Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual. Inland Revenue has assessed the magnitude of the administrative impacts and considers that a decision to grant the Trust overseas donee status can be implemented for the start of the 2018–19 income year (1 April 2018), subject to amending legislation being enacted before 31 March 2019.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Inland Revenue would monitor the Trust to confirm that it is meeting its purposes if it is granted overseas donee status. Monitoring the Trust would be done through existing relationships Inland Revenue has with relevant stakeholders and their advisors, as part of its administration of the Inland Revenue Acts (the Income Tax Act 2007, the Tax Administration Act 1994, and the Goods and Services Tax Act 1985).

7.2 When and how will the new arrangements be reviewed?
The process for granting overseas donee status is based on an upfront analysis and vetting process. Charities that are granted overseas donee status may be the subject of routine audit or investigation by Inland Revenue if information comes to hand that warrants administrative intervention. Irrespective of Inland Revenue's tax administration, charities that are granted overseas donee status are required to comply with the requirements of the Charities Act 2005. Non-compliance with the Charities Act, evidence of wrong-doing, or other action that is contrary to the application of the Inland Revenue Acts may warrant further advice to the Government to the effect that the charity's overseas donee status should be removed.

Regulatory Impact Statement: Sales suppression software

Coversheet

Purpose	
Decision Sought:	*Introduce penalties for the supply, possession, and use of sales suppression software*
Advising Agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Revenue*
Date:	*1 June 2021*

Problem Definition

Inland Revenue has been informed that overseas businesses may be selling sales suppression software (software which alters sales data for the purpose of evading tax) is being made available to businesses in New Zealand. This software is relatively new to New Zealand and existing tax law appears insufficient to deter its spread in the New Zealand tax base.

Executive Summary

Sales suppression software appears relatively new to New Zealand, and its distribution is not expressly covered in existing tax law. Using the software is a form of tax evasion, and users could be penalised on that basis. However, it is not currently an offence to make, sell, buy, or possess the software, meaning that the software can spread in the tax base without repercussions, to the point where removing it from the base is likely to be very difficult. Action is required to give authorities the legal tools to deter the spread of the software.

Overseas jurisdictions have employed two broad methods to curtail the spread of sales suppression software. The first approach uses penalties (both civil and criminal) that are targeted at taxpayers who make, sell, acquire, possess, or use the software. The second approach is regulating point-of-sale systems used in the country to ensure that the systems are incompatible with sales suppression software. Given that the problem appears new to New Zealand (and evidence suggests there is little market penetration) and the compliance costs of regulation are high, we currently favour the penalty approach over a regulatory regime.

A penalty regime carries minimal compliance costs for taxpayers who are not using the software, and its administrative costs can be absorbed within Inland Revenue's existing investigation and prosecution functions. Working properly, penalties should sufficiently deter taxpayers from supplying, acquiring, or using sales suppression software that the software is unable to take a deep hold in New Zealand, thereby maintaining the integrity of the tax base and ensuring a level playing field for taxpayers.

Limitations and Constraints on Analysis

The problem being addressed is new to New Zealand, and as such our proposal is not constrained by Ministers' commissioning or by any prior policy decisions. To some extent, it is constrained by legal norms for offences and imposing penalties.

We do not have data on the existing reach of sales suppression software in New Zealand. Although this software has been around internationally in various forms for some time there is no evidence that it has become prevalent in New Zealand yet. This assumption has been formed from discussions with relevant Inland Revenue staff including staff responsible for review and audit of businesses which would be expected targets of sellers of sales suppression software.

As the subject matter is sensitive, we have not widely consulted on this issue. We have consulted with the Ministry of Justice, the Treasury, the Department of Internal Affairs, and Inland Revenue internal experts on evasion and sales suppression, as well as officials from the Australian Taxation Office. We have also discussed the issue with Chartered Accountants Australia and New Zealand and the New Zealand Law Society. Consulted parties support the Government taking steps to respond to the issue and, in general, are supportive of the preferred option.

Responsible Manager(s) (completed by relevant manager)

Paul Fulton

Principal Policy Advisor

Inland Revenue

1 June 2021

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the *Sales suppression software* RIA prepared by Inland Revenue and considers that the information and analysis summarised in the RIA meets the quality assurance criteria.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem?

1. Inland Revenue has been informed by competent authorities[1] from Australia and the United Kingdom that a UK-based company may be selling sales suppression software to hospitality businesses in New Zealand. Sales suppression software systematically alters point-of-sale data collected by a business in order to understate or completely conceal revenues for the purpose of evading tax.

2. The OECD has identified a number of risks for tax administrations arising from the vulnerability of electronic cash register data to sales suppression software and consequent under-reporting of income. Overseas jurisdictions have reported significant revenue losses to software-enabled tax evasion in cash-heavy business sectors such as hospitality and retail. A 2013 OECD report[2] recommended tax administrations consider criminalising the providing or possession or use of electronic sales suppression software.

3. Sales suppression software appears to be new to New Zealand, and it is not covered by New Zealand's existing regulatory systems. There are only limited mechanisms to prevent the software from spreading through the New Zealand tax base. While its usage is a form of tax evasion and could be penalised as such, it is not illegal to manufacture, sell, supply, acquire, or possess the software. Existing promoter penalties cannot be applied to suppliers of sales suppression software as they only apply to promoters of tax avoidance arrangements, rather than evasion. This means Inland Revenue has limited means of prosecuting or penalising software suppliers, which is likely the most efficient method of deterring the software's spread.

4. Left unchecked, sales suppression software risks becoming embedded in New Zealand businesses. There are strong incentives for businesses in cash-heavy sectors to adopt the software; as businesses using software to suppress their sales data will be able to evade their tax obligations, they will have an advantage over their rivals who are not using software. This will create pressure on businesses to adopt the software to stay competitive with their rivals, which endangers taxpayers' voluntary compliance with their obligations.

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[1] A competent authority is a person in a revenue agency who, amongst other tasks, can share relevant information with other tax jurisdictions.

[2] https://www.oecd.org/ctp/crime/ElectronicSalesSupression.pdf

What is the policy problem?

5. Sales suppression software presents a threat to the integrity of the New Zealand tax system. It provides an easy-to-use, difficult-to-trace mechanism for businesses to reduce their income tax and GST liabilities. In this way, sales suppression software undermines the principles of voluntary compliance and self-assessment; it provides both method and motive for a taxpayer to be non-compliant and reduces Inland Revenue's ability to detect instances where taxpayers have incorrectly self-assessed their income.

6. As business income tax and GST taken together constitute a major portion of government revenue, spread of the software among businesses may lead to material reductions in revenue. OECD data suggests that revenue losses from sales suppression software can be very high.[3] For instance, Revenu Québec estimated Québec's tax losses to sales suppression software at $CA417 million in 2007-2008, while a professor at Boston University estimated in 2017 that up to $US20 billion of state sales tax revenue may be being lost per annum across US states. During 2006-2010, Sweden's tax agency audited a variety of industries including hairdressers, clothing stores, and food stores, and showed that businesses in these industries were routinely under-reporting 20-40% of their turnover.

7. The spread of sales suppression software throughout the New Zealand tax base could pose similar major revenue losses to those that have been reported in other jurisdictions. The Crown's income tax and GST intake would be reduced as the tax base diminishes, which will have implications for government spending on other issues.

8. The widespread presence of sales suppression software in the New Zealand tax base would also create horizontal equity issues, as the software allows certain taxpayers to artificially reduce their tax bill, creating unfairness between compliant businesses and offending businesses. This would also lead to imperfect competition, as businesses using the software to commit tax evasion would be at an advantage over rival firms which are compliant with their tax obligations. This would create pressure on compliant firms to adopt the software to keep up with their competitors, further eroding the principles of voluntary compliance on which the New Zealand tax system is based.

What objectives are you seeking in relation to the policy problem?

9. Prevent spread of sales suppression software in the New Zealand tax base.

10. Minimise taxpayers' ability to use sales suppression software.

11. Minimise compliance burden on taxpayers who are following the rules.

12. Minimise administrative costs of ensuring compliance.

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[3] E.g. *Electronic Sales Suppression: a threat to tax revenues (2013)*, pp.6-7 and corrigendum.

Section 2: Deciding upon a preferred option to address the policy problem

What criteria will you use to compare options to the status quo?

13. The criteria being used to consider the options are as follows:
    a. Sustainability of the tax base
    b. Compliance costs
    c. Administration costs

What scope will you consider options within?

14. Our options are not constrained by any previous policy decisions or legislation.

15. We have refined our approach to penalty setting following engagement with the Ministry of Justice. Additionally, we have consulted with the Department of Internal Affairs, the Treasury, Chartered Accountants Australia and New Zealand, and the New Zealand Law Society – these discussions have informed our response.

16. Experience from other countries, particularly Australia, Canada, and the United Kingdom, has been considered in determining our options. We have also considered relevant material published by the OECD.

17. Options considered to address the issue fall broadly into two categories:
    a. a penalty response illegalising various activities in relation to sales suppression software
    b. a regulatory response that places standards on EFTPOS machines sold in New Zealand which prevent taxpayers from using the software.

18. These two options are based on approaches taken by other jurisdictions to address this issue.

What options are you considering?

Option One – Counterfactual

19. The counterfactual is that the government takes no additional regulatory action to prevent the spread of sales suppression software. Although Inland Revenue can to an extent mitigate the spread of software through its existing evasion penalties, this is unlikely to be sufficient to deter its spread altogether. There is a major risk that the software would spread through the tax base and undermine its integrity, potentially leading to significant revenue losses in income tax and GST.

Option Two – *Penalty regime*

20. This option would introduce civil and criminal penalties to make manufacturing, selling, providing, acquiring, or possessing sales suppression software illegal. As usage of the software is inarguably a form of tax evasion, a separate penalty for this is not needed.

The new penalties allow Inland Revenue to target suppliers of software, which is likely to be a more efficient means of preventing the spread of the software than prosecuting end-users under existing evasion penalties. The desired outcome is that taxpayers are deterred from adopting the software, maintaining the integrity of the tax base.

21. The proposed approach introduces criminal penalties on making, selling, or supplying the software of up to $250,000. It also introduces criminal penalties for acquiring or possessing the software of up to $50,000, and a civil penalty for the same behaviour of $5,000. The maximum penalty of $50,000 proposed for the criminal penalty for acquisition or possession is intended to be on par with the maximum penalty for evasion or similar offence,[4] while the criminal penalty of $250,000 proposed for making or selling software is set in line with the Australian model, which imposes a penalty for making or selling at a rate five times that of the penalty for usage.[5]

22. This approach is based on the Australian Taxation Office (ATO)'s experience in applying similar penalties. The ATO's approach is to find users of sales suppression software and charge them with criminal penalties, trace the software back to the seller and charge them as well, and then trace the seller's sales down to other purchasers of the software. However, as the ATO has noted that these purchasers are generally very high in number, they advise us that the cost-effective approach is to levy civil penalties against these users *en masse*, rather than take them individually through the Courts. At its discretion, Inland Revenue can prosecute major offenders identified in this way using criminal penalties, while applying the civil penalty against smaller offenders (in addition to evasion shortfall penalties where applicable). Consistent with existing shortfall penalties, the civil penalty will be reduce or eliminated if a taxpayer with the software makes a voluntary disclosure.

23. It is also proposed to specifically remove eligibility for the existing 50% reduction of the civil evasion penalty for prior behaviour when the evasion included use of sales suppression software. This is because the prior behaviour reduction is intended to take into account situations when a taxpayer has no prior history of non-compliance. However, evasion involving sales suppression software requires the taxpayer to acquire the software (itself a premeditated act of non-compliance) and therefore already establishes a history of non-compliance with their obligations under the Inland Revenue Acts.

24. A sufficiently robust penalty regime increases the financial risk of selling and owning sales suppression software. The purpose of this is to deter taxpayers from engaging in these behaviours. There are limits to this effect, as there will be some taxpayers who will take compliance risks if they perceive the rewards are great enough.

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[4] Refer section 143B of the Tax Administration Act 1994.

[5] Respectively, 5,000 penalty units for making or selling versus 1,000 for usage. A penalty unit is (as of the time of writing, 25 May 2021) worth AU$222 at the federal level, equating to AU$1,110,000 and AU$222,000.

25. We expect the compliance costs for this option are low to non-existent for taxpayers not engaged in offensive behaviour, as they will not need to change their behaviour. Taxpayers who commit an offence and are caught will face high costs, but this is by design.

26. The option requires Inland Revenue to actively audit taxpayers and prosecute offenders. This will impose some administrative costs on an ongoing basis, but these would fall within Inland Revenue's normal auditing functions, so any additional cost is unlikely to be significant.

Option Three – *Regulatory regime*

27. This option would impose regulations on EFTPOS machines sold in New Zealand to make these machines incompatible with sales suppression software. Businesses would be required to upgrade their systems in line with these new regulations.

28. A number of models exist overseas which we could base our approach on, including so-called "fiscal till" systems (used by jurisdictions such as Argentina, Bulgaria, Lithuania, and Russia) and "certified" cash register systems (used by e.g. Belgium, Greece, and Sweden). There are differences between the two approaches, but in essence they both place requirements on cash registers used in certain industries to store, track, and upload sales data in secured formats and/or to secure servers.

29. The Dutch government has taken a voluntary compliance approach to regulation through its Keurmerk (Quality Mark) system, establishing an industry body with representation from the Belastingdienst (the Dutch tax authority) and point-of-sale system manufacturers to set quality standards for systems sold in the Netherlands. Compliant systems receive a Keurmerk label; businesses using these systems are considered lower risk under the Belastingdienst's fraud risk management systems.

30. A regulatory option is likely to go farthest in preventing the spread of the software and protecting the integrity of the tax base, as it makes the software incompatible with business point-of-sale systems and thereby removes its usefulness. However, the option is likely to impose significant compliance costs on all businesses, even those not using sales suppression software, as all businesses would need to upgrade or replace their systems to meet the new regulatory standards. The option also has relatively high initial administrative costs, as the government must design a set of regulatory standards that meet the policy objective.

How do the options compare to the counterfactual?

	Option One – *Counterfactual*	Option Two – *Penalty regime*	Option Three - *Regulatory regime*
Compliance costs	0	0 *Businesses not using software will not need to alter their behaviour.*	- - *Businesses will need to replace their point-of-sale software, imposing high costs.*
Administrative costs	0	0 *Administrative requirements are largely already met by existing Inland Revenue functions.*	- *Setting regulations will require high upfront effort, but this cost will diminish over time.*
Sustainability	0	+ *A penalty regime will discourage sale or purchase (but some taxpayers may risk it).*	++ *Regulations will greatly reduce utility of the software, discouraging uptake.*
Overall assessment	0	++ *This option is effective while having a low compliance/administrative cost.*	+ *This option is likely to be extremely effective but comes with high costs.*

Key:

++	much better than the counterfactual
+	better than the counterfactual
0	about the same as the counterfactual
-	worse than the counterfactual
- -	much worse than the counterfactual

What is your preferred option?

31. Establishing an appropriate penalty regime (Option Two) should deter the spread and incidence of sales suppression software in the New Zealand tax base, as taxpayers who might otherwise have been inclined to use or sell the software would be discouraged by the penalty rates. It cannot be guaranteed that this will discourage all taxpayers; however, if it is sufficiently robust to discourage enough of them, the ability of vendors of the software to penetrate the New Zealand market will be greatly curtailed and the software may never take sufficient foothold in the tax base to require more substantial (and perhaps more costly) action. This option also has the benefit of having very low compliance costs for taxpayers who are meeting their obligations, as they do not have to change any aspect of their business or behaviour to continue to be compliant with the law. It does impose some administrative costs, as Inland Revenue must expend resources on auditing taxpayers and taking the non-compliant to court (which then ties up the Courts' resources).

32. An effective regime of regulating the quality of EFTPOS systems sold in New Zealand (Option Three) would greatly reduce opportunities for non-compliance through sales suppression software. If the software cannot be used to suppress sales, it becomes valueless to taxpayers, so its spread throughout the tax base is unlikely (but also not likely to cause much damage to the base if it does occur). However, the major drawback of a regulatory regime is its significant compliance costs. Requiring all businesses using EFTPOS systems in New Zealand to upgrade or replace their systems would be imposing a major compliance burden to resolve a problem that is not currently widespread (as far as we know). Compliance costs are also placed on the vendors of EFTPOS systems, who would need to ensure their products are meeting the standard. Option Three also requires a major investment to establish a sensible regulatory framework, as well as ongoing costs to make sure the regulations stay up to date.

33. Officials prefer Option Two. A penalty regime targeted at specific offenders is a more appropriate response to the current scale of the problem than a regulatory response that affects the entire tax base. It is inefficient to impose burdens on all users of EFTPOS systems to resolve an issue where there is no evidence at this time suggesting the issue is widespread in New Zealand. An approach that targets noncompliant taxpayers directly is likely to be more efficient and have smaller economic costs than an approach that targets all users of EFTPOS systems.

34. Stakeholders were generally supportive of Option Two as an approach to deal with the issue. They have not expressed significant support for Option Three, although we have not discussed Option Three in depth with them. Certain stakeholders raised the following concerns:
    a. Some stakeholders were concerned that instituting a penalty for possession in addition to the existing evasion penalty might lead to a double jeopardy situation in which taxpayers are effectively being charged twice for the same offence.
    b. Other stakeholders cautioned against making the proposed offences offences of strict liability, as Australia has done, and suggested that a requirement of criminal intent be added to the offence definitions.

35. Officials will take these comments into consideration when developing the legislation and accompanying Commentary on the Bill giving effect to the preferred option.

What are the costs and benefits of your preferred option?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Regulated groups (taxpayers who would otherwise use sales suppression software)	Ongoing cost of not being able to use software to suppress sales (therefore higher tax to pay) One-off cost of paying penalties if caught	High	Medium
Regulators (Inland Revenue)	Ongoing cost of auditing and prosecution	Low	High
Taxpayers not using sales suppression software	No costs	None	High
Wider government	Ongoing cost of courts' time in trying offenders	Low	High
Total monetised costs		-	
Non-monetised costs		*Low*	
Additional benefits of the preferred option compared to taking no action			
Regulated groups (taxpayers who would otherwise use sales suppression software)	No direct benefit	None	High
Regulators (Inland Revenue)	Additional tools to use against taxpayers identified using the software	Medium	High
Taxpayers not using sales suppression software	Ongoing benefit of market competition remaining fairer	High	Medium
Wider government	Ongoing benefit of maintaining revenue base and existing taxation levels	High	Medium
Total monetised benefits		-	
Non-monetised benefits		*High*	

36. The major assumption underlying this cost-benefit analysis is that the penalty regime effectively deters taxpayers from adopting or providing sales suppression software. This is a reasonable assumption as the proposed penalty rates are high and are expected to significantly discourage taxpayers.

37. However, some taxpayers may choose to take the risk; whether this will happen in sufficient quantities to pose a problem will be determined by the size of the penalties and taxpayers' perception of their chances of the behaviour being identified. As such, the evidence certainty entry for these effects in the above table has been set at Medium.

38. The table also assumes that the costs of administering the scheme will largely fall within the existing costs of upholding compliance across the tax system and any additional cost will therefore be relatively minor. For this reason, although the individual cost of evasion cases can be quite high, the overall costs for regulators are set at Low; should the penalties work as intended, few cases will need to be taken to court and the overall administrative burden should be low.

39. Inland Revenue conducts compliance work on a risk prioritisation basis. To the extent the introduction of new penalties increases the penalty for a person undertaking this behaviour, it may result in resources being reallocated to identify sales suppression software and away from relatively lower priority work.

Section 3: Delivering the preferred option

How will you implement the preferred option?

40. Enforcement of the new penalty regime will be a matter for Inland Revenue. Inland Revenue also handles tax prosecutions and will therefore be the agency prosecuting offenders. The new penalties thus have minimal implementation costs, as the mechanisms by which it will be implemented (Inland Revenue's auditing and legal functions) are already in place.

41. The penalties will come into effect from the enactment date of the Bill they are included in, which will likely be the next available omnibus taxation Bill. Taxpayers will be notified when the contents of this Bill are publicly announced.

42. As the penalties are not retrospective, there is a risk that notifying taxpayers of the issue before the penalty is in place will lead to an effective grace period in which taxpayers are aware of the issue and can buy, sell, and possess the software without being subject to any legal consequence aside from the existing evasion penalty. This may increase the spread of the software through the tax base before any effective countermeasure can be deployed. However, this is unavoidable under the standard approach that activity that is not illegal at the time it is undertaken will not subsequently become so retrospectively.

43. Inland Revenue runs public awareness campaigns from time to time on areas it considers are a high risk; an awareness-raising action such as a Revenue Alert could be considered as part of its normal prioritisation process.

How will you monitor, evaluate, and review the preferred option?

44. Inland Revenue's existing taxpayer compliance specialists will be responsible for the ongoing monitoring of the effectiveness of the new penalties (as part of their regular work of monitoring taxpayer behaviour and the general level of taxpayer compliance). We will be able to determine the degree to which the penalties succeed in deterring the spread and use of sales suppression software through this work. Monitoring the actual level of business income tax and GST paid to Inland Revenue and comparing it to expected levels will also provide useful insight.

45. The work of reviewing the success of the new penalties will also fall to Inland Revenue's existing compliance specialists, who will inform officials if further measures or development are required. It will likely take some time for the effects (or lack thereof if the regime succeeds) of sales suppression software to be felt in the tax base. Any review of the regime's effectiveness will therefore need to be conducted at some delay.

Impact Summary: Tax pooling to purchase backdated tax

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
The key constraints on the below analysis is data. As the proposed change would benefit a demographic who currently cannot use backdated tax, it is difficult to fully scope who would use it in these circumstances if they could. There is also a behavioural element to the change that is also difficult to objectively measure. Relatedly, this has limited the scope of consultation and understanding of the scale of impacts as it is difficult to perfectly identify individuals who would specifically benefit from this change. Evidence of the scale of the issue is largely case-specific and/or anecdotal and we recognise that a number of the parties who have raised it, such as tax poolers, have a vested interest in the change. In considering the issue, officials primarily considered the status quo as an alternative. Comparing the options, it became apparent that, irrespective of scale, allowing the use of tax pooling to satisfy liabilities that arise from voluntary disclosures for more than income tax and Resident Withholding Tax (RWT) is the right policy outcome. This is because it increases simplicity, coherence and integrity within the tax system In light of the above constraints, the below analysis has assumed that a voluntary disclosure would be more likely to be made if tax pooling were available more widely to satisfy any tax debt and mitigate Use of Money Interest (UOMI). In addition to the existing tax types covered (income tax and RWT), this means that the tax types covered by this extension are tax paid or payable under the pay as you earn (PAYE) rules, employer superannuation contribution tax (ESCT) rules, retirement savings schemes contributions tax (RSCT) rules, non-resident withholding tax (NRWT) rules, goods and services tax (GST) or fringe benefits tax (FBT).
Responsible Manager (signature and date):

Bary Hollow Tax Administration Policy and Regularity Stewardship Inland Revenue

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
Partially meets
Reviewer Comments and Recommendations:
The Quality Assurance reviewer at Inland Revenue has reviewed the Tax Pooling to purchase backdated tax Impact Summary and considers that the information and analysis summarised in it partially meets the quality criteria of the Regulatory Impact Analysis framework. This is because, as identified in the Key Limitations or Constraints on Analysis section, there is no data to support the current scale of the problem or the impact of the proposed changes if they were enacted. However, the Impact Summary sets out the rationale for why the status quo is an issue and why a regulatory change is preferred, and identifies the main risks and uncertainties.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Tax pooling was introduced to assist with uncertainties relating to provisional tax (income tax). It allows provisional tax payments from numerous taxpayers to be grouped into the account of a registered intermediary. By pooling these payments, a taxpayer can offset an underpayment against amounts within the same pool allowing them to reduce their exposure to use of money interest (UOMI).

The coverage of tax pooling was later extended to include historical periods and other tax types, but only in a situation of reassessment of a prior assessment or an increase of a prior obligation. This necessitates that an original assessment has been issued for that tax period or an obligation to pay tax has been quantified because a relevant tax return has already been filed. Taxpayers who have filed and who subsequently wish to make a voluntary disclosure are able to use tax pooling to satisfy the increased tax debt.

However, where there is no existing assessment or quantified obligation the taxpayer would be unable to use tax pooling to satisfy a liability arising from the same voluntary disclosure. There is a limited exception to this rule as certain voluntary disclosures for income tax and resident withholding tax (RWT) may use tax pooling, subject to a Commissioner's discretion measured against specific legislative criteria.

There are several circumstances where a taxpayer may have unintentionally not filed a tax return for a particular tax type and tax period. For example, a small business may be unaware that an employee benefit they provide is subject to fringe benefit tax and so do not provide a return. Where these omissions have been made in good faith, it is disproportionally punitive to not allow taxpayers to use the benefits of tax pooling in these situations should they want to do so.

Allowing the use of tax pooling to satisfy liabilities arising from a voluntary disclosure would therefore encourage voluntary disclosure in these instances. It would result in more consistent outcomes across tax types. Such a change is in line with tax principles and offers the best policy outcome.

Extending the exception to other tax types would take a legislative change to expand existing provisions. These other tax types are tax paid or payable under the PAYE rules, ESCT rules, RSCT rules, NRWT rules, GST or FBT. This change will not impact existing settings for income tax and RWT,

2.2 Who is affected and how?

The demographic whose behaviour would be most impacted by this change are taxpayers who have not filed a return due to an error or oversight (other than for income tax or RWT) and who could or would like to use tax pooling in order to meet the liability. They would be more likely to make a voluntary disclosure under this change than take a risk on the error not being found through audit. This would improve the accuracy of returns and the rate of tax collected. As errors cannot be predicted, equally those who benefit from this change will likely vary considerably between tax years.

The types of business most likely to benefit will be smaller businesses. That is to say, those with employees but not large enough to employ or permanently engage tax advisors. Although not prohibited, larger businesses should be more informed and sophisticated taxpayers and are therefore considerably less likely to meet the requirements of this change.

2.3 What are the objectives sought in relation to the identified problem?

The primary objective of this change is to improve the rate of voluntary disclosures and thereby increase the accuracy of tax returns and tax collected. This is linked to a secondary consideration of improving fairness within the tax system by not being overly punitive on errors related to different tax types.

The other key objective of this work is to protect and enhance the integrity of the tax system.

These objectives are similar in their focus and they have been given equal weighting with regard to considering this proposal.

Section 3: Options identification

3.1 What options have been considered?

There are concerns that the current rules could be disincentivising voluntary disclosures where the disclosure does not relate to a tax type that can currently use tax pooling to satisfy the liability. Instead, taxpayers may be choosing to risk the error not being caught in an audit rather than disclose it and face the additional cost of UOMI.

Two key options were considered in addressing this issue:

- Status quo
- Enabling the use of tax pooling to purchase backdated tax to satisfy a liability arising from a voluntary disclosure for tax types other than income tax and RWT where a return has not previously been returned.

Other options were considered but were not progressed due to limitations such as not being able to fully address the identified issue of inconsistent treatment between tax types or of reducing system integrity. These options were to reduce penalties associated with liabilities arising from voluntary disclosures or increasing education and compliance activities to reduce errors. Similarly, initial thought was given to the removal of tax pooling as an option however this was not progressed. Tax pooling emerged in response to the inherent inaccuracy that is a feature of the provisional tax regime so its cessation would remove flexibility and increase the punitive aspect of the regime. This is inconsistent with intended policy outcomes.

These options were considered in light of the degree to which they address the issues of incentivising voluntary disclosure, fairness, enhancing the integrity of the tax system and associated administrative and compliance costs.

Under the status quo, where a taxpayer finds they have made an error – for example, not realising an employee benefit is subject to Fringe Benefit Tax (FBT) and therefore not providing a return – they are obliged to make a voluntary disclosure to the Commissioner of Inland Revenue so their tax liability can be adjusted to account for the FBT liability. As this represents an underpayment, the FBT would attract UOMI and thereby increase the amount the taxpayer is obliged to pay to Inland Revenue. The taxpayer is not able to use tax pooling to reduce their exposure to UOMI in this instance.

Where the error relates to RWT or income tax and a voluntary disclosure is made, the taxpayer is able to purchase backdated tax from a tax pool. Purchasing backdated tax reduces the amount of UOMI they are subject to as purchased funds are credited from the day they are added to the pool rather than the day they are purchased.

Alternatively, a taxpayer may choose to not make a voluntary declaration in the hope that the error is not discovered through audit and their tax liability therefore does not increase.

Under the proposal to enable the use of tax pooling to satisfy tax liabilities arising from voluntary disclosures where the taxpayer has not previously filed a return, the taxpayer would be able to use tax pooling, and thereby mitigate their exposure to UOMI, for voluntary declarations related to tax types other than RWT and income tax. This is expected to increase the number and amounts of voluntary disclosures.

We recognise that there is a risk that this proposal could be seen as encouraging non-filing of returns. The option to alter the status quo therefore includes measures to ensure the integrity of the tax system is not undermined through the wilful non-filing of returns. These measures are the requirement for the taxpayer to make the disclosure before Inland Revenue has engaged with them (or their agent) regarding that tax type, and for the disclosure to have been made in a reasonable timeframe of the error being discovered. A penalty is also proposed where the Commissioner is satisfied that the debt has arisen through the taxpayer choosing not to comply with their tax obligations

This option would require legislative change to both the Income Tax Act 2007 and Tax Administration Act 1994 to enable taxpayers to use tax pooling for a voluntary disclosure where the taxpayer has not previously filed an original return. (i.e., the voluntary disclosure is not for a reassessment or amending a prior obligation). The Income Tax Act change is to allow for the use of tax pooling to satisfy a tax liability that has arisen from a voluntary disclosure where there is no original return. The Tax Administration Act change is to enable the use of shortfall penalties where the Commissioner is satisfied that the debt has arisen through the taxpayer choosing not to comply with their tax obligations. Such changes would represent the expansion of existing provisions rather than the creation of new ones.

Further options to achieve the intended outcome of increasing voluntary disclosures were considered and ruled out. Primary amongst these was consideration of reducing the penalties and interest that could be applied for liabilities arising from voluntary disclosure. This was ultimately rejected as there are integrity concerns to providing additional 'discounts' or exceptions to existing interest and penalty rules related to voluntary disclosures. These concerns include the risk of incentivising intentional omissions followed by disclosures in order to achieve a reduced tax liability. As the underpinning penalty framework is considered sound, focus has been placed on reducing inconsistent outcomes between tax types which are the subject of voluntary disclosures.

Similarly, an approach focussed on education and enforcement was considered. Although important, such an approach would only go so far in reducing instances of voluntary disclosures as it is not possible to mitigate all potential for error or misunderstanding. Ensuring that taxpayers are supported to do the right thing when such an error is discovered is one of the reasons that voluntary disclosures are a feature of the tax system. Accepting this, an approach solely focused on education and enforcement would not address the identified issue of inconsistent outcomes between tax types which are the subject of voluntary disclosures.

3.2 Which of these options is the proposed approach?

The proposed approach is to enable taxpayers to use tax pooling for a voluntary disclosure where the taxpayer has not previously filed an original return, as it will support an increase in voluntary disclosures. It will do so by ensuring that voluntary disclosures are treated equally with regard to their ability to utilise tax pooling to mitigate UOMI and thereby achieve greater consistency of outcomes across tax types.

Overall, it will improve simplicity and consistency within the tax system compared to the status quo whilst upholding system integrity.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Additional costs of proposed approach, compared to taking no action		
The Crown	Improved compliance would reduce the UOMI the department collects.	Low – as the outcome is linked to behavioural changes it is hard to measure but, as the demographic is small, these changes are also anticipated to be small.
Inland Revenue	More voluntary disclosures, potentially an increase in the need to verify these disclosures meet the criteria, and processing of penalties where they are found to not meet criteria. These represent an increase in administrative costs.	Low – this proposal represents an extension of existing settings and so changes should be straight-forward and small. Similarly, the demographic incentivised to make voluntary disclosures under this change is small, meaning the increase in contacts with Inland Revenue should be equally small.
Total Monetised Cost	As noted, as costs and benefits are intrinsically linked to behavioural change it is difficult to put a value on them. Overall, the costs are likely to be low.	Low
Non-monetised costs		Low

Expected benefits of proposed approach, compared to taking no action		
Taxpayers	Assuming full compliance irrespective of the change, this proposal would reduce costs to the taxpayers by mitigating UOMI.	Low – tax pooling enables the mitigation of UOMI, but the tax liability would not be impacted by this change. Due to links with behavioural changes, this is hard to measure.
Taxpayers	Voluntary disclosures are incentivised therefore it is easier and less punitive to do the right thing.	Medium – although as a behavioural factor this is difficult to fully gauge.
Tax poolers	By increasing the potential number of taxpayers able to use tax pooling, this would increase the income of tax poolers.	Low - as a small demographic increase, the income increase would also be small.
The Crown	Improved compliance rates will increase the amount of tax collected.	Low – as the outcome is linked to behavioural changes it is hard to

		measure but, as the demographic is small, these changes are also anticipated to be small.
The Crown	Penalties from voluntary disclosures that have not met the necessary criteria to use tax pooling in these instances would increase the amounts collected by the Inland Revenue and therefore the Crown.	Low - as a small demographic of an already small demographic increase, the income increase would be equally small.
Total Monetised Benefit		As noted, as costs and benefits are intrinsically linked to behavioural change it is difficult to put a value on them. Overall, the costs are likely to be low.
Non-monetised benefits		Medium

4.2 What other impacts is this approach likely to have?
Inherent in this change is that, by increasing voluntary disclosures that are influenced by the ability to use tax pooling, the use of tax pooling is also likely to increase. This is not inherently either negative or positive, however it may be worth noting that the funds available via tax pooling are finite (i.e., funds that can be purchased are only available up to the total amount that has been deposited with the pool). Increasing the ability to use tax pooling could mean that tax pool funds are not always able to meet demand.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

This is a discrete issue and, as noted above, due to the nature of those likely to benefit from it, it is difficult to effectively target consultation.

In addition to internal stakeholders within Inland Revenue, entities consulted were:

- Tax pooling intermediaries;
- PricewaterhouseCoopers;
- Chartered Accountants Australia and New Zealand; and
- Corporate Taxpayers Group.

Stakeholders were supportive of the problem analysis and the proposed approach. Although several of the entities listed above are tax poolers, that support for the change was universal amongst those consulted. This supports the view that the proposed option is a positive change that will benefit taxpayers and the wider tax system. Overall, all are satisfied that the proposed change will realise the intended benefits and is adequately balanced against the risk of exploitation and potential fiscal impacts.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
A legislative change is required to give effect to this change. Once legislated, a number of focussed system changes would be required. These involve the extension of existing settings, and implementation risks are therefore minimal. Inland Revenue would be responsible for the ongoing operation and enforcement of changes. The option is proposed to come into effect from 1 April 2022.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
The primary indication of whether the intended outcome is achieved is if we see an increase in voluntary disclosures related to these tax types. Data is available around those who use tax pooling to satisfy tax liabilities arising from voluntary disclosures currently and so uptake can be monitored. Given who is intended to benefit from this change (i.e. individuals who make an error in good faith), there should not be 'regulars' who use this legislation. Inland Revenue collects data on who is making voluntary disclosures and what they entail and so would be able to review if patterns of repeat non-filing followed by disclosure emerge.

7.2 When and how will the new arrangements be reviewed?
There is no specific plan to review this legislation. However, Inland Revenue is in regular and ongoing engagement with the wider tax advisory community and it is likely that members will be a proactive and effective source of feedback on the operation of the change. Additionally, in light of the monitoring outlined above, the changes will be reviewed where voluntary disclosures under the new legislation increase significantly, a number of taxpayers are found to use the legislation repeatedly or, conversely, where the legislation does not appear to be used at all.

Impact Summary: Tax treatment of cryptocurrencies

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be made by Cabinet.

Key Limitations or Constraints on Analysis

Due to the nature of blockchain and distributed ledger technology, there are a number of constraints on the data that is available for analysing the policy problem. First, it is very difficult to determine the identify or tax residency of a crypto-asset user or the counterparty to any given transaction. Second, there are many crypto-assets (over 10,000) and the underlying technology is extremely complex and constantly evolving. These issues could pose an inherent challenge to crypto-asset tax compliance generally.

It is noted that these constraints have not had a large impact on the current proposals. This is because the preferred option was for a broad exemption to exclude crypto-assets from GST and the Financial Arrangement (FA) rules, which makes identifying an individual's identity and tax residency along with the underlying crypto-assets that they invested in not as relevant. These constraints could be more important if one was looking at applying different treatment depending on the nature of the crypto-asset or required mechanisms to determine tax residency to enforce tax compliance. We suspect that these issues may be greater constraints when wider reform options for income tax are undertaken.

Responsible Manager (signature and date):

Graeme Morrison
Policy Lead
Policy & Regulatory Stewardship
Inland Revenue

31 May 2021

Quality Assurance Reviewing Agency:

Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Tax treatment of cryptocurrencies* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.
Reviewer Comments and Recommendations:
The reviewer’s comments on earlier versions of this Regulatory Impact Assessment have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Background

Crypto-assets are digital assets (commonly known as coins or tokens) that use cryptography to secure transactions and verify the transfer of the coins or tokens. Instead of relying on a financial institution to verify transactions, crypto-asset transactions are confirmed by computers operating on the currency's network (distributed ledger technology).

Tax rules in New Zealand and many other countries do not contemplate crypto-assets and can be difficult to apply as crypto-assets will often not fit into existing definitions that were designed for other investment products such as fiat currency or shares. Because of their innovative nature, they will often also have different features to these other investment products.

Due to the nature of blockchain, we do not have a sense of scale as to how many New Zealand tax residents are crypto-asset users or holders. However, on a global scale the number of crypto-assets and the amount of money that is invested in them has been growing prolifically over the last couple of years (at time of writing there are over 10,000 crypto-assets with a global market capitalisation of almost $1.7 trillion dollars).

Current law

The current position is that crypto-assets are likely to fall within the scope of existing GST rules (although this position is unclear). Although GST does not apply to money or financial services, crypto-assets are not money for the purposes of the GST Act. Under current law, the application of GST to crypto-assets would vary depending on the facts, the features of the crypto-asset and the residency of the parties to the transaction. The supply of a crypto-asset could either be subject to GST at 15%, an exempt financial service, or a zero-rated supply to a non-resident.

If GST were to apply to crypto-assets this could create biases to sell to non-residents (zero-rated) and would result in double taxation in some cases (e.g. if a car dealer sold a car and accepted a payment in bitcoin the dealer would have to account for GST on the sale of the car for bitcoin, and then a second time when transferring that bitcoin into NZD).

In this regard, the current GST rules provide an uncertain and variable GST treatment. This could make using or investing in crypto-assets less attractive than using money or investing in other financial assets. Similarly, applying the FA rules to crypto-assets would lead to accrual based taxation on large unrealised gains and losses and could bias investment decisions. The FA rules are complex to apply and do not apply to shares (which are a similar investment product).

2.2 Who is affected and how?

Holders of crypto-assets: Anyone who holds crypto-assets is potentially impacted by the GST treatment of these assets. This includes investors, New Zealand businesses which issue crypto-assets or accept them as payment, and NZ based exchanges. Anyone that is GST registered who holds crypto-assets will be confronted by the GST treatment upon the disposal of their asset (potentially including trading one crypto-asset for another, selling it for money or trading it for other goods). As the current law is unclear, there is likely to be a high degree of non-compliance or inconsistent treatment being applied across the board.

More generally, it can also be argued that the current ambiguity in the rules means that *potential* users of crypto-assets are disincentivised from using or investing into these assets.

2.3 What are the objectives sought in relation to the identified problem?

- It is intended that crypto-assets should have a similar tax treatment to other investment products or asset classes which are close substitutes for the crypto-asset (it is not intended that crypto-assets would receive a concessionary treatment);
- NZ crypto-asset holders are not disadvantaged from issuing or selling tokens in NZ (relative to selling tokens outside NZ or capital raising through other means); and
- any solution does not impose undue compliance costs or create perverse incentives.

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options:

- Certainty: It should be clear how the tax rules operate so that affected parties can plan their affairs accordingly.
- Policy sustainability: Crypto-assets are an emerging market. There are over 10,000 crypto-assets with various functions and constantly changing uses. It is important that the rules are stable enough to future proof against changes in this area.
- Compliance costs and administration costs: These should be minimised where possible. It is noted that crypto-assets have many different rights and features and are constantly changing. If prescriptive categorisations are required then this adds compliance costs for the taxpayer.

Option one: Status quo but provide more guidance

Pros:

- No legislation change would be required.

Cons:

- Given the many potential GST treatments that could apply to crypto-assets under existing law, this approach would potentially be more time consuming than enacting legislation.
- Would not have the legal weighting that legislation has.
- Would fail to future proof against future changes in the crypto-asset market.
- Would fail to reduce the complexity of the existing law and therefore still burdens taxpayers with heavy compliance costs to determine how their respective assets fit within guidance.
- Would not solve any of the problems identified to the extent that guidance on existing law determined that it did apply (e.g. if guidance on existing law determined that the FA rules applied to a particular crypto-asset then the taxpayer would still be subject to accrual based taxation on potentially large unrealised gains).

Option two: Token classification framework and deeming rules

This option would develop a framework for categorising different types of crypto-assets and use this to create deeming provisions that apply across all Revenue Acts. For example, crypto-assets could be categorised as a utility, security or asset token based on their particular rights and features, and then be given a tax treatment similar to other asset classes that hold such features.

Pros:

- This approach is principled and tax neutral. For example, it would provide a neutral tax treatment for those crypto-assets which are close substitutes for existing financial products such as currency or shares, whereas other tokens (such as utility tokens) could be subject to GST.

- Comprehensive: A taxpayer would have the advantage of being able to apply all the existing law that stands behind each respective classification. For example, if a particular crypto-asset was deemed to be money, the taxpayer could apply all relevant tax law and guidance that applied to money to their crypto-asset.

Cons:

- This approach assumes that crypto-assets all have similar uses to existing financial products. This may not be the case, meaning that existing rules may be impractical to apply to a number of crypto-assets.

Option three: Broad definition

This option would prioritise specific changes that create the most significant policy issues when applied to crypto assets (applying GST and the FA rules lead to significant policy and practical issues when applied to crypto-assets). The approach then creates a broad definition of “crypto-asset” and excludes those that meet the definition from GST and the FA rules (by classifying them as an excepted FA).

Pros:

- Utilising a broad definition of crypto-assets best future proofs against changes in the crypto-asset market. A broad definition prevents the need for regular reviews.

Making supplies of crypto-assets not subject GST

- Making crypto-assets not subject to GST creates certainty (under current principles the treatment would vary greatly depending on the residency of the buyer, the nature of the crypto-asset and the facts of the scenario at hand).
- Avoids compliance costs associated with categorising crypto-assets for purposes of determining GST treatment.
- Ensures NZ investors are not disadvantaged from selling tokens in NZ compared to overseas (zero-rated). It is also more attractive for businesses to undertake capital raising ventures with crypto-assets in NZ if they are not subject to GST and exempt from FA rules.[1]
- Avoids double or multiple taxation that can occur when crypto-assets are used as a payment for an underlying supply.

Exempting from FA rules

- Avoids the application of the FA rules: if the FA rules were to apply to some crypto-assets and not others (similar in kind to other assets to which financial arrangements apply) then this creates inconsistencies. This would result in accrual-based taxation on large unrealised gains and losses from volatile crypto assets and the consequent biasing of investment decisions if some are taxed on a realisation basis and others aren’t.

1 Another option would be to exempt them from GST. If crypto-assets were exempt from GST, a GST-registered person who makes supplies of crypto-assets to non-residents (zero-rated) would be able to claim GST input credits. This would make it more attractive for these persons to sell to non-residents. In order to ensure NZ businesses and investors are not disadvantaged when they sell crypto-assets to other NZ residents, removing crypto-assets from the GST net altogether is the preferred approach.

- Subjecting crypto assets to the FA rules also creates compliance costs: individual would be required to convert their crypto-assets into NZD, spread income over the term of the arrangement and undertake a base price adjustment.

Cons:

- If adopted, this proposal would not actually reduce the compliance cost of applying other tax rules (such as working out the income tax profit or loss, or record-keeping).
- Does lack accuracy to some extent as all crypto-assets regardless of their features would not be subject to GST and exempt from the FA rules.

Option four: Develop a standalone set of tax rules for cryptocurrencies

Pros:

- Comprehensive: Having a 'codified' body of law in respect of crypto-assets (for both income tax and GST) that prescribes comprehensive treatment for these assets for all aspects of tax would be very comprehensive and more accessible given it would be centralised in one place.
- Future proofed: Any future changes to crypto-assets would be more amenable to amendment if the laws that applied to these assets were all set out in one space and not intertwined with existing tax settings that were designed without any contemplation of crypto-assets (which were probably not in existence at that time).
- Reduction in compliance costs.

Cons:

- Risk of getting it wrong: It is noted that there would be risk in undertaking a comprehensive standalone set of rules for crypto-assets at this stage. This is still a developing area that is not yet well understood, and it would be best to understand it fully and how it develops in light of existing tax settings before attempting something more comprehensive.
- Time consuming (would require a lot of analysis, consultation and policy resource and would take a long time to develop, consult and implement).

3.2 Which of these options is the proposed approach?

Officials' preferred option is option three – applying a broad definition to crypto-assets and then focussing on the issues that provide the most problems from a policy perspective (being to make crypto-assets not subject to GST and exempt from the FA rules). It is noted that this option would also be supplemented to include the use of guidance to ensure that these changes were communicated and easily understood.

This option is preferable because:

- Compliance costs: The compliance costs to categorise and apply existing tax law to all crypto-assets (as would apply under the status quo or when designing a token classification framework) together with the compliance costs borne by individuals in determining which classification applies to their particular assets, outweighs the revenue neutrality benefit of a more prescriptive system. Having to determine the residency of the counter party to a transaction would also be required if GST potentially applied, and this is almost impossible with crypto-assets.

- Certainty: This option provides the most certainty as all crypto-assets will be exempt from the FA rules and not subject to GST.

- Sustainability: A broad exemption future-proofs the industry against future changes that would require constant reclassification under a token classification framework approach.

- Although option 3 is the best in the short term and is what is proposed in the Cabinet paper, officials will continue to work to develop and consult on option 4 as a second phase of potential reforms at a later date. This could help address other issues and concerns in this area.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties (GST registered owners of crypto-assets)	It is expected that the preferred option aligns with tax positions taken by nearly all taxpayers, so there would be no impact on them nor compliance costs. It is possible that some taxpayers will have taken tax positions based on the current law and a grandparenting provision would be provided to preserve those positions so they would be unaffected.	None/low
Regulators (Inland Revenue)	There should be no revenue impact. Given that the current law regarding GST, FAs and their application in respect of crypto-assets is unclear, it is understood anecdotally that not many taxpayers have taken a tax position in respect of their crypto-asset holdings. As mentioned above, a grand parenting clause will preserve tax positions already taken.	None/low
Wider government	No expected costs	
Other parties	No expected costs	
Total Monetised Cost		None/low
Non-monetised costs	It is noted that these changes will bring a small administrative cost to IR in terms of providing guidance and answering queries to aid taxpayer understanding and promote compliance.	Low

Expected benefits of proposed approach, compared to taking no action		
Regulated parties (GST registered owners of crypto-assets)	Although anecdotally the number of taxpayers that have returned GST on the sale of crypto-assets is low, removing them from the GST net will result in certainty for taxpayers.	Medium

	Note that GST will continue to apply to supplies of goods and services which are brought using a crypto-asset as the 'currency'. Taxpayers will also have far fewer compliance costs, as they would not be required to consider the GST treatment of their various crypto-asset holdings going forward.	
Regulators	Creates certainty in the law and therefore future proofs this space against future queries from taxpayers (which requires resources to respond to)	Medium
Wider government	Provides certainty regarding the wider crypto-asset market	
Other parties	No expected benefits	
Total Monetised Benefit	Hard to quantify as whether GST would have applied would largely depend on the nature of the transaction.	Low
Non-monetised benefits	Reduction in compliance costs for taxpayers over time	Medium

4.2 What other impacts is this approach likely to have?

There are unlikely to be any further material impacts of this approach.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Who has been consulted? What was the nature of their interest?

This issue was consulted on as part of the release of the *GST policy issues – an officials' issues paper*. Inland Revenue received submissions from private sector tax advisers as well as from some crypto-currency groups, such as Blockchain NZ.

Do they agree with your analysis of the problem and its causes?

Yes. The submissions received on this issue in the GST issues paper outlined similar considerations to what has been discussed in this RIA (see above and in the pros and cons section of the discussion options).

Do they agree with your proposed approach?

Submitters were largely supportive of our preferred approach which is to provide a broad definition of crypto-assets and make those crypto-assets not subject to GST and exempt from the FA rules. CA ANZ preferred the first option, being the development of a token classification system and deeming rules, but did note that if this principled framework was not developed then they would support a broad definition option.

Has your proposed approach been modified as a result of stakeholder feedback?

Yes. Submitters have provided some valuable input into the detailed design of the proposals. Some examples of how the proposed approach has been modified as a result of stakeholder feedback includes how 'crypto-asset' should be defined, which is important to ensure the workability of the proposals, along with the potential inclusion of a grand parenting clause for prior tax positions (noting that these proposals would be retrospective to 1 Jan 2009, being the inception of bitcoin).

As the proposals also intend to exempt crypto-assets from the application of the FA rules (with the exception of crypto-assets with features that make them economically equivalent to debt arrangements), submitters noted the need for an anti-avoidance provision to prevent any deliberate abuse (e.g. an issuer of bonds converting its bond instruments into tokens for the purposes of reducing the tax impact for its investors).

Submitters also stressed the need for greater levels of guidance, which resulted in preparing for a more comprehensive approach than was in the issues paper (i.e. the issues paper advocated for the 'broad definition' approach as discussed earlier in this RIA, but this will now be supplemented with additional guidance to address submitters concerns).

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposals will require amendments to the Goods and Services Tax Act 1985 and the Income Tax Act 2007, and could be included in the next available omnibus tax bill (expected to be introduced in August 2021). Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with Select Committee and after the bill is enacted (by way of inclusion in a Tax Information Bulletin). The proposals have been subject to consultation via a GST issues paper and would be subject to the standard legislative process. It therefore follows that there will be sufficient time for people to react to and understand the changes. The proposals are quite simple in their execution (i.e. excluding crypto-assets from the Financial arrangements rules and GST) and align with existing taxpayer practices so are therefore unlikely to create any implementation risks.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Officials will continue to engage with submitters and other stakeholders to ensure the rules are operating correctly and to determine whether any remedials or further changes are required.

7.2 When and how will the new arrangements be reviewed?
There are no plans to undertake a formal post-implementation review of these changes. These changes are taxpayer friendly and simply ensure that the law accords with what most taxpayers have been doing in practice (i.e. by clarifying the application of the FA rules and GST to crypto-assets). That said, officials will continue to engage with submitters to ensure the rules are operating correctly and to determine whether any remedials or further changes are required. As we have developed relationships with stakeholders throughout consultation on the issues paper, this engagement channel is open to stakeholders should they wish to provide feedback on the legislation.